Article

Windfalls

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I. INTRODUCTION

> [W]indfall as a term for an unexpected piece of good fortune goes back to medieval England, when commoners were forbidden to chop down trees for fuel. However, if a strong wind broke off branches or blew down trees, the debris was a lucky and legitimate find.[1]

In common usage, a windfall is a "casual or unexpected acquisition or advantage," or an "unexpectedly large or unforseen profit."[2] A rare discussion in the legal literature did not stray far from the dictionary, defining a windfall as "value which is received by a person unexpectedly as a result of good fortune rather than as a result of effort, intelligence, or the venturing of capital."[3] This definition, however, adds critical economic content to the term: It distinguishes gains due to luck from those due to effort or enterprise. This Article defines windfalls as *economic gains independent of work, planning, or other productive activities that society wishes to reward.*

The common law has long provided clear protection for the fruits of labor, planning, and risk-taking. Property and tort law protect Farmer Black's wheat crop from theft, negligent destruction, and other harms traceable to wrongful human conduct. Contract law protects Black's right to transfer the wheat in a private bargain for whatever price the market will bear. Modern constitutions, via contract and just compensation clauses, and modern statutes, in myriad ways, have further expanded protections for private property.

Perhaps surprisingly, Farmer Black receives as much legal protection for manna fallen from heaven or, to use a less religious hypothetical, for a golden meteor that falls onto Blackacre. Most commentators simply presume, in passing, that the law treats property obtained by luck no

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1. WILLIAM MORRIS & MARY MORRIS, MORRIS DICTIONARY OF WORD AND PHRASE ORIGINS 605 (1977). For an equivalent etymology, see ROBERT HENDRICKSON, THE FACTS ON FILE ENCYCLOPEDIA OF WORD AND PHRASE ORIGINS 722 (1997).

Commoners' right to take windfallen wood was far from universal in medieval England. Local forest wardens, as a perquisite of office, sometimes had the right to sell "wind-fallen wood." CHARLES R. YOUNG, THE ROYAL FORESTS OF MEDIEVAL ENGLAND 78 (1979). At other times the Crown claimed the proceeds from sales of windfallen timber. *See id.* at 115, 126, 170.

2. 20 OXFORD ENGLISH DICTIONARY 378 (2d ed. 1989) [hereinafter OED]. The OED traces usage back to Erasmus, who used the term to describe inheritance as a windfall. *See id.* (citing THE APOPHTHEGMES OF ERASMUS (Nicolas Udall trans., London, Robert Roberts 1877) (1542)). Under the economic definition of the term, it is not so clear that inheritance is a windfall. *See infra* Subsection IV.B.2.c. The OED traces the modern use of the term "windfall" to describe extraordinary and unexpected profits to JOHN MAYNARD KEYNES, *The General Theory of Employment Interest and Money*, *in* 7 THE COLLECTED WRITINGS OF JOHN MAYNARD KEYNES 57 (rev. ed. 1973). *See* OED, *supra*, at 378.

3. Comment, *Taxation of Found Property and Other Windfalls*, 20 U. CHI. L. REV. 748, 748 (1953).

differently than it treats property earned through effort. In upholding the constitutionality of a Washington, D.C., rent control law enacted during World War I, Justice Holmes noted that the measure would deprive landlords "in part at least of the power of profiting by the sudden influx of people to Washington caused by the needs of Government and the war, and thus of *a right usually incident to fortunately situated property*."[4] A recent scholarly discussion of the famous Coronation Cases[5] notes in passing that although "this asset came to [apartment owners] by the purest windfall, it was entitled to no less protection than any other species of property."[6] Thus, Richard Epstein accurately describes a "uniform rule [that] leaves the thing with its founder, without any effort to isolate luck from skill."[7]

I take issue with this deeply ingrained notion, both as a positive description of the law and as a normative prescription for the law. Some legal rules do—and should—dictate that the state capture windfalls, i.e., tax them away from their lucky recipients and redistribute the gains to the rest of the population. Part II develops a theoretical framework to demonstrate that such sharing of windfalls is sometimes desirable. Societal capture of windfalls, by definition, does not affect incentives to engage in productive activity and therefore does not discourage effort or enterprise. Windfalls, compared to earnings, are thus an attractive source of revenue. Moreover, to the extent that citizens are risk-averse, they will desire, if possible, to share windfalls rather than leave them with a few lucky individuals. There is no private market mechanism for redistributing windfalls (a hypothetical product that I label "reverse insurance"), despite these desirable attributes, because parties experiencing gains are unlikely to report their good luck. In contrast, those with ordinary insurance have clear incentives to report bad luck covered by their policies. I label this the "reporting problem"; it explains why society cannot count on the market to redistribute windfalls.

The state, however, can redistribute windfalls. Society must weigh the benefits against two types of costs incurred in capturing and redistributing windfalls. First, there are significant transaction and administrative costs.

4. Block v. Hirsh, 256 U.S. 135, 157 (1921) (emphasis added).

5. The Coronation Cases involved contract disputes arising from the cancellation of celebrations in honor of the coronation of King Edward VII (who became ill days before the scheduled festivities). Parties that contracted for rooms along parade routes, boats able to cruise to the "illumination of the fleet," and similar services wished to rescind contracts and recover down payments. Sellers of these services, of course, wished not only to retain down payments, but to receive balances due. The primary case was *Krell v. Henry*, 2 K.B. 740 (Eng. C.A. 1903), which held that a party letting rooms along the parade route could retain the down payment but that a contract was otherwise rescinded because its purpose had been frustrated. For citations to 10 other opinions on contracts frustrated by the King's illness, along with extensive background on the disputes, see R.G. McElroy & Glanville Williams, *The Coronation Cases*, 4 MOD. L. REV. 241 (1941).

6. Andrew Kull, *Mistake, Frustration, and the Windfall Principle of Contract Remedies*, 43 HASTINGS L.J. 1, 26 (1991).

7. Richard A. Epstein, *Luck*, 6 SOC. PHIL. & POL'Y 17, 18 (1988).

Second, any sharing regime that accidentally affects earnings, as opposed to windfalls, will create disincentives to effort and especially to planning.

Another important limitation on capture is that, more often than not, one person's windfall is another person's loss. Unfortunately, golden meteors fall from the sky much less frequently than people find the property of others, receive overpayments, or benefit from other "redistributionary" windfalls. I label cases where the number of parties to a windfall is small (including both losers and winners) "private windfalls."

Part III first explores how courts have used and abused the windfall label. By failing to appreciate the extent of parties' planning, and the productivity of such planning (recall the definition, above, of a windfall as an "economic gain independent of work, *planning*, or other productive activities"), courts often find a windfall where none exists (Section III.A). Contracts, primary tools of planning, are always incomplete. Courts create unintended windfalls when they construe contracts without assuming that, had they anticipated subsequent events, risk-averse parties would have adopted terms avoiding (instead of creating) windfall gains for one side and losses for the other (Section III.B). Legal rules sometimes leave windfalls where they land in order to serve larger social goals: Permitting finders to keep property when the true owner is unidentified encourages finders to take control of lost items and attempt to locate the owner; permitting victims of negligent acts to recover from injurers as well as from their insurers preserves tort law's incentives to take reasonable precautions (Section III.C). While society might wish to recover other private windfalls, the same reporting problem that prevents a market in reverse insurance also makes capture of private windfalls unattractive. All the state accomplishes by imposing a tax on private windfalls is to impose transaction costs on the few parties who must act in concert to keep the windfall secret (Section III.D).

"Public windfalls" involve cases where the number of winners and losers is large. Unlike private windfalls, capture of public windfalls is feasible. Any gain that looks like an economic rent, from higher oil prices resulting from the activities of a foreign cartel to increased wartime demand for apartments, presents an attractive target for taxation and redistribution. Section IV.B explores a wide variety of contexts in which governments have engaged in windfall capture. Section IV.C examines slightly different situations, such as eminent domain and punitive damage awards, where legal rules should and often do permit the state to buy goods or encourage efficient behavior at market cost instead of at negotiated prices that would allow a lucky few to reap windfalls.

Societal capture of public windfalls was not practical when states were relatively weak and lacked the information or organizational apparatus necessary to separate windfalls from earnings. As governments have developed, however, they have become more and more capable of capturing public windfalls.

II. THE THEORY AND PRACTICE OF CAPTURING WINDFALLS

There are two reasons why, in an ideal world, the state would capture—tax away and redistribute—windfalls: (1) They are a nondistortionary source of revenue; and (2) risk-averse citizens will desire sharing windfalls as a sort of "reverse insurance." I defend these propositions in Section II.A. Reality, however, imposes significant constraints on even the modern state's ability to capture windfalls: Transaction/administrative costs and the possibility of creating disincentives to productive activity (especially planning) may outweigh the benefits of windfall capture. I examine these costs in Section II.B.

A. *The Desirability of Capturing Windfalls: Optimal Taxation and "Reverse Insurance"*

Almost any tax causes consumers to change their behavior. This process leads to economic losses above and beyond tax revenues—"excess burden" or "deadweight loss" in the jargon of economics.[8] A tax on chicken causes some consumers to substitute, for example, pork, which they might otherwise prefer not to eat; a wage tax causes workers to take leisure time that, in the absence of the tax, they found less attractive than additional income. Whenever taxes cause individuals to alter their behavior, society suffers such deadweight losses.

Conversely, the less a tax changes behavior, the less deadweight loss it imposes. All else being equal, it is efficient to tax goods for which demand is inelastic—unresponsive to price changes—since consumers will simply pay more rather than switch to a less preferable substitute.[9] Thus, a tax on the insulin that diabetics require to survive, while perhaps inequitable, is efficient in that it generates less deadweight loss than taxing most other goods.

Taxing windfalls is efficient for precisely the same reason that taxing insulin is efficient: It leads to little if any distortion in private behavior and thus imposes little if any deadweight loss. Windfalls by definition are unearned surprises.[10] Taxing unearned income does not undermine

8. *See, e.g.*, RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 277-96 (5th ed. 1989).

9. *See id.* at 293.

10. It is the unearned feature that defines windfalls. The phrase "unearned surprise" may seem redundant. Most surprises are unearned (windfalls), and most earnings are expected. There are, however, examples of unsurprising windfall-type gains (for example, an expected inheritance)

incentives for effort and enterprise; taxing surprises cannot distort agents' economic planning. "Of great appeal to economists are taxes that capture some portion of windfalls to individuals. If these windfalls are due to chance or luck, then taxing them may be less likely to distort behavior than would other taxes."[11] Windfall taxation is nondistortionary since it can only be imposed ex post, after a windfall, which is by definition an unanticipated event. "[T]axing past transactions means that future behavior may be less distorted. . . . The central idea is that allocative efficiency is served when taxpayers are unable to shift their activities in the face of a tax."[12]

One court made precisely this point in ruling that insider trading profits recovered by a corporation were taxable income. The key to the ruling was that the corporation's recovery fit within the statutory definition of income as "gains or profits and income derived from any source whatever."[13]

> We see no reason for not giving the statutory language its natural meaning, as to the money here in question. It was, to be sure, a "windfall" to the plaintiff. *If Congress were to select one kind of receipt of money which, above all others, would be a fair mark for taxation, it might well be "windfalls." That would not penalize industry nor discourage enterprise or economy as taxes on wages, salaries and profits do.*[14]

Windfalls are in some ways akin to economic rents—returns to assets that "exceed the minimum amount necessary to keep it in its present employment."[15] The most fertile tracts of land, to take the classic example, can produce corn at a cost below market price, since market price is determined by the least productive acre in production (the "marginal" acre). This divergence between cost and price gives rise to rents. The cost of windfalls is by definition zero, and thus earnings from windfalls are

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and surprise earnings (for example, a stock in a consciously diversified portfolio that exceeds expectations, or a seller landing a big contract after working hard on the deal while still calculating the odds of success as well below 50%). That a gain is a surprise, however, supports a presumption that it is an unearned windfall.

11. Gene Steuerle, *Progressive Taxation and Windfall Incomes*, 62 TAX NOTES 1197, 1197 (1994); *see also* Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 556 (1986) ("[T]he revenue effects of windfall taxation may make it desirable because such benefits might exceed [costs] in terms of the optimal trade-off between incentives and risk-spreading.").

12. Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEGAL STUD. 265, 273 (1993).

13. Park & Tilford Distillers v. United States, 107 F. Supp. 941, 942 (Ct. Cl. 1952) (quoting 26 U.S.C. § 22(a) (1946)).

14. *Id.* at 942 (emphasis added). The *Park & Tilford* court held that the payment of insider trading profits to a corporation from an officer under section 16(b) of the Securities Act of 1934 is taxable income under section 22(a) of the Internal Revenue Code of 1934. The court failed to note one reason Congress might not have viewed corporate recovery of insider trading profits as a windfall: Section 16(b) clearly aims to recruit corporations as private attorneys general so as to deter insider trading. To the extent that such lawsuits serve public ends, they are not windfalls.

15. WALTER NICHOLSON, MICROECONOMIC THEORY 485 (3d ed. 1985).

rents. The most important point, for purposes of efficiency analysis of windfall capture, is that the taxation of rents does not alter agents' economic decisions.

Not all rents are windfalls. An oil company that engages in calculated risks and discovers a field yielding oil at a cost far below market price will reap rents, but they are *earned* rents, and hence they are not a windfall. Michael Jordan commanded an eight-digit annual salary for playing basketball because of his unique talents; his wage for any other activity (for example, playing baseball) would have been considerably lower. Yet he invested considerable time in honing his skills and exerted effort every time he played. Hence, his salary was not a windfall under this Article's definition.

Even if windfalls exceed the government's budgetary needs, there is a second reason for society to capture windfalls: individuals' risk preferences. There is a widespread belief, buttressed by extensive empirical evidence, that people are risk-averse: They are willing to trade off chances for large gains to insure against large losses.[16] Thus, for example, most people do not invest their savings only in very risky enterprises; rather, they choose instruments more likely to experience moderate gains and unlikely to go bust. Property owners pay insurance premiums in hopes that they will never file a claim and thus never recover premiums paid.

Leaving windfalls "where they fall" means that a few individuals experience large gains while most receive nothing. Ex ante, before anyone knows who will be the lucky recipients of windfalls, risk-averse citizens will not find appealing the idea of leaving windfalls where they fall. They will prefer to capture the windfalls and distribute them evenly over the entire citizenry. I label such a redistributionary scheme "reverse insurance." Like insurance it spreads the "risk" of surprises, though insurance spreads the risk of unpleasant surprises while windfall capture and redistribution spreads the "risk" of pleasant surprises.[17]

Those unfamiliar with economic theory may be puzzled by this symmetric treatment of bad and good luck. The word "risk" may be one source of confusion, since its popular use is limited to bad luck. It is important, then, to note the benefits that citizens obtain from windfall capture even assuming everyone is risk-neutral. By raising revenue via a nondistortionary tax, windfall capture reduces deadweight losses. It will

16. For an accessible theoretical discussion of risk aversion, see *id.* at 203-09. The huge and varied markets for insurance are perhaps the strongest evidence that most individuals are risk-averse. Insurance markets and similar mechanisms give rise to "[t]he general presumption in economics . . . that people are risk-averse over gambles affecting a significant proportion of their wealth." ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 63 (1988).

17. While in common parlance the word "risk" is associated with the possibility of only adverse outcomes, in economics and finance it refers more generally to unpredictability and thus includes favorable as well unfavorable possibilities.

also reduce the tax bill (be it income tax, sales tax, or whatever other levy the windfall tax displaces) of the vast majority that do not enjoy significant windfalls. The expected size of this reduction is far from trivial. First, some individual windfalls are large (for example, during its heyday the Windfall Profit Tax on Oil, discussed in Subsection IV.B.2, raised over $126 billion in 1998 dollars, or roughly $550 for every American then alive). Second, the aggregated value of numerous modest windfalls may be significant.

The popularity of lotteries is sometimes taken as evidence that many people are not risk-averse. It is important to remember, however, that many of the same lottery players betting a couple dollars a week also spend significantly more on indemnity insurance for their homes, cars, and other possessions. Lotteries may reflect small-scale irrationality or demonstrate that people are risk-loving with a small part of their wealth but, as shown by the prevalence of insurance, risk-averse as to the bulk of it. Edward McCaffery offers an intriguing explanation for the popularity of lotteries: It is rational for relatively poor people to use a few marginal dollars each week to provide them with some (if limited and actuarially unfair) hope of the good life.[18]

Although it is possible to explain lotteries and other seemingly risk-loving behavior as either minor deviations from the standard assumption of risk aversion or as no deviation at all, studying windfalls raises another issue: Are people's preferences the same for upside risk as for downside risk? That is, do they wish to share upside gains the same way that they wish to share downside losses? Economic theory, as noted above, treats risk, upside and downside, as symmetric, and thus it suggests that people would like to share windfalls just as much as they like to insure against downside risk. Ultimately, however, this is an empirical question about the nature of common predilections. We will return to this issue after illustrating important similarities, and differences, in pooling upside versus downside risk.

There are pervasive parallels between spreading the risk of bad luck and sharing the bounty of good luck. Consider the following table, which illustrates when conventional insurance does and does not make sense.

18. *See* Edward J. McCaffery, *Why People Play Lotteries and Why It Matters*, 1994 WIS. L. REV. 71, 93-99.

TABLE 1. CONVENTIONAL INSURANCE

	Frequent Types of Losses	Infrequent Types of Losses
Large Losses	Hell: uninsurable and hopefully uncommon. Either the world has gone to hell, or the insured are unusually accident-prone or negligent.	The paradigmatic case for insurance: The modest premiums of the many are sufficient to pay the claims of the unfortunate few.
Small Losses	Administrative/transaction costs make insurance too expensive.	

Since pooling risks via insurance involves nontrivial administrative costs, insurance works only to spread larger potential losses. If a certain type of large loss occurs quite frequently, however, insurance again becomes unworkable since the size of premiums begins to approach the size of losses. There is little point for insured parties to shuffle funds into a central pool when most of them will make claims roughly equal to their contributions.

Now consider a parallel table breaking down the viability of reverse insurance based on the size and frequency of windfalls.

TABLE 2. REVERSE INSURANCE

	Frequent Types of Gains	Infrequent Types of Gains
Large Gains	Heaven: Frequency is strong indication that gains are due to effort and enterprise and hence not windfalls. By definition, very few people are systematically lucky.	The focus of this Article: This is a paradigmatic case for reverse insurance. Risk-averse individuals pool bounties just as they pool downside risk.
Small Gains	Administrative/transaction costs make reverse insurance too expensive.	

Just as the costs of administering insurance make conventional insurance coverage infeasible for small losses, one thesis of this Article is that, given such costs, windfall capture makes sense only for larger windfalls. Again following conventional insurance, I posit that windfall capture makes sense only for infrequent types of gains. Recurring gains are likely due to effort and enterprise and hence, by definition, are not windfalls.

Another important similarity between conventional and reverse insurance is that in both cases, limiting "coverage" in various ways is important to avoid perverse incentives. For conventional insurance, this is the ubiquitous moral-hazard problem: Coverage may give insured persons inadequate incentives to take cost-effective precautions.[19] Homeowners may not take simple low-cost steps to prevent fires, such as installing smoke detectors; a fully insured car owner may park on the street instead of in a safer garage; a contact-lens wearer with insurance against loss may exercise less care in keeping track of the lenses. To minimize these problems and avoid unnecessary losses, insurance companies may require their customers to take certain measures (for example, installation of smoke detectors) or leave them with some risk of loss (for example, deductibles or coinsurance, so that an insured party is not covered for 100% of a loss).

For reverse insurance, the analogous moral-hazard problem is that an overly broad definition of windfalls will lead society to take not only surprise income, but also income resulting from effort and enterprise. This outcome would create serious disincentives to create wealth. For example, from a risk-sharing point of view, it might make sense for all the graduates from a class of the Harvard Business School to agree to share their incomes after graduation, since luck will undoubtedly play a role in their relative earnings. Effort and enterprise, however, also play a significant role in determining who earns what, and such a sharing contract would wreak havoc on incentives to be productive. Capture ideally would be limited to wealth gained purely by good fortune. The key here, as with the moral-hazard problem in conventional insurance, is to provide coverage—capture—only for random events beyond the control of the insured.

Given the myriad similarities between conventional and reverse insurance, it is perhaps surprising to find an incredibly rich market for the former and absolutely no market for the latter. The absence of a reverse-insurance market to share windfalls makes a prima facie case that people simply do not desire such sharing. There are, however, complications facing a reverse-insurance market that are not present in a conventional insurance market. These sources of market failure, as opposed to consumer preferences, likely explain the lack of a private market mechanism for sharing windfalls and justify governmental measures to provide reverse insurance.

19. *See, e.g.*, COOTER & ULEN, *supra* note 16, at 65-66 ("Moral hazard is the name for the problem that arises when the behavior of the insuree changes *after* the purchase of insurance so that the probability of loss or the size of the loss increases."); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 194-97 (1987) (discussing the moral hazard problem and some partial solutions).

First, to avoid mangling incentives, reverse-insurance contracts must be considerably more complex and variable than conventional insurance contracts. Life insurance deals with one very simple and easily identifiable event: death. Casualty insurance, whether for boats, cars, homes, or other property, similarly deals with another easily identifiable event: damage to property. Insurance companies can use mass marketing, boilerplate contracts, uniform claim procedures, and the like to pool risks cheaply. In contrast, reverse insurance would require terms that varied from case to case. What constitutes a windfall, as opposed to earnings, will vary extraordinarily from wheat farming to doctoring to steelmaking. The costs of serving as the insuring hub in a series of "spoke" contracts with variegated insured parties may swamp the benefits of sharing windfalls.

Even if reverse-insurance companies could set up a series of contracts with enough individuals to share windfalls effectively, they would face a second and perhaps more serious reporting problem. In both conventional and reverse insurance, the insured party is in a good position to observe losses or gains, while it is quite expensive for the insurer to detect events that trigger loss coverage or gains sharing. There is a radical difference, however, in insured parties' incentives to reveal events invoking the policy. Under conventional insurance, the insured party obviously has every incentive to report losses—she stands to collect money. Under reverse insurance, the opposite holds: The insured party will have to share a windfall if she reports it, and hence she has absolutely no incentive to report her good fortune. To the extent that it is prohibitively expensive for insurers to detect windfalls, this dooms any private market for reverse insurance. Given market failure, there is a role for government intervention to provide some of the benefits of windfall capture that a risk-averse citizenry desires.

Thus, the paucity of markets for sharing windfalls cannot be taken, without more, as evidence that people simply do not wish to do so—that is, that people are not risk-averse with respect to upside risk. To the contrary, Part IV presents a series of instances in which democratically elected governments have implemented complex schemes designed to spread unearned gains over the entire populace. To the extent that democracy works and official acts reflect popular will, these episodes constitute empirical evidence that people generally are risk-averse as to upside, as well as downside, risk.

A government wishing to effectuate reverse insurance would put the population on notice that it stands ready to tax away windfalls. As long as the government limits capture to windfalls as defined in this Article, such a policy will not affect anyone's behavior: The government will act only for events not planned for or anticipated in even a statistical sense. While a reverse-insurance program would have little, if any, impact on asset prices the day it was announced, it would prevent property from appreciating after the property benefited from a windfall. Buyers would know, or should know, that the government is likely to tax the windfall no matter how many times it changes hands. Hence, the value of the windfall will not be capitalized into the price of the asset.[20]

Before discussing limits on even the state's ability to capture windfalls, it is important to note that optimal taxation and risk preferences provide efficiency reasons for capturing windfalls: If properly implemented, they improve social welfare. The redistribution of windfalls, of course, does not increase the aggregate amount of goods available. Capture provides less tangible but equally important benefits: a less burdensome means of raising revenue and a reduction in the volatility of personal incomes.

The case this Article makes for windfall capture, then, does not rely on any controversial notion of equity, fairness, justice, or the like. There is, of course, wide disagreement about what is equitable, fair, or just; such notions are subject to debates at least as old as recorded political thought. Efficiency arguments have much broader appeal precisely because they rely on the relatively uncontroversial proposition that people prefer more stuff, less burdensome taxes, and less risk.[21] This is especially true when, as with windfall capture, the rules are likely to sprinkle the incremental wealth over the entire population, improving everyone's welfare.[22]

B. *Limits to Capturing Windfalls*

The previous Section briefly touched on two limits to windfall capture. First, administrative and transaction costs make capturing small windfalls unattractive. This was the sum and substance of the bottom row in Tables 1

20. "[C]apitalized into the price of the asset" means that the price of the asset has been adjusted to reflect some known present or possible future influence. Thus, for example, when the value of a parcel of land rises due to the discovery that it likely contains a gold mine, we say that the likelihood of the mine's existence has been capitalized into the price of the land. Similarly, the mortgage interest deduction has made homes more valuable and has undoubtedly been capitalized into home prices. For an amusing and deceptively profound discussion of capitalizing the value of the mortgage interest deduction into property prices, see BORIS I. BITTKER, *Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?*, *in* COLLECTED LEGAL ESSAYS 547, 547-52 (1989).

21. Efficiency does have its critics. *See, e.g.*, *Debate: Is Law and Economics Moral?*, 24 VAL. U. L. REV. 147 (1990); *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980).

22. A policy that leaves at least one person better off without harming anyone exemplifies efficiency in the strongest sense of the word: pareto efficiency. Windfall capture, considered ex post, is not pareto efficient since it leaves the windfall recipient worse off. Considered ex ante, however, windfall capture that does not require excessive adminstrative costs is efficient under two less demanding standards: Societal gains exceed losses (Kaldor-Hicks efficiency), and over the long term covering many windfalls, everyone is statistically likely to be better off if the state captures windfalls (quasi-paretian efficiency). For a general discussion of these and other definitions of efficiency, see JULES L. COLEMAN, MARKETS, MORALS, AND THE LAW 95-132 (1988).

and 2. In general, a society should capture windfalls only if the benefits exceed the costs. Capture makes the most sense for windfalls that are large, easy to detect, and easy to redistribute. Note that the rise of the modern state, with its better information and extensive tax infrastructure, means that the costs of capturing windfalls have fallen over time.

The second limit on windfall capture discussed above involves incentives: To the extent that decisionmakers err in distinguishing windfalls from gains due to effort and enterprise, individuals will have diminished inducement to work hard and produce wealth. And the line between windfalls and earnings is not always easy to draw. There is no dichotomy between windfalls and earnings; rather, there is a continuum. As discussed in Subsection IV.B.2.c, heirs under intestacy statutes may look like windfall recipients. While the efficiency arguments for allowing them to retain their inheritances may be weaker than the argument for beneficiaries identified in a will, many of the same considerations are in play, such as encouraging the living to work and to save.

One way to think about limiting the definition of windfalls is to imagine what factors very careful, thorough, and prudent investors would capitalize into asset prices. If some contingency that relatively careful investors might have anticipated increases the value of the property, then this possibility was probably capitalized into the price of the asset. There is then no windfall, but merely reward commensurate with risk taken. On the other hand, some events are real surprises. They are either completely unprecedented, or they had such extraordinarily low odds of occurring ex ante that even very careful planners would not have accounted for them. For instance, I will argue in Subsection IV.B.2 that the Organization of Petroleum Exporting Countries' (OPEC) success in limiting supply and raising oil prices in the early 1970s was largely unexpected. While it is true that "[e]veryone knows that unanticipated benefits are worth having at least to some degree,"[23] such surprises by definition do not enter into planning, effort, or enterprise.

It is important to realize the breadth of factors that careful investors will consider and capitalize into asset prices—and that all such planning is productive activity and hence not a windfall under this Article's definition. For example, Kaplow has argued powerfully against providing transitional relief to taxpayers harmed by revisions to the Internal Revenue Code, and he has symmetrically argued against a windfall tax on those benefiting from such changes in the law.[24] The tax code changes almost constantly, and thus

23. Richard A. Epstein, International News Service v. Associated Press*: Custom and Law as Sources of Property Rights in News*, 78 VA. L. REV. 85, 123 (1992). Epstein agrees that "the social losses generated by *not* creating the property right [for unanticipated benefits] seem fairly small." *Id.*

24. *See* Kaplow, *supra* note 11, at 551-53.

it is difficult to argue that careful investors do not weigh a wide variety of tax contingencies in their decisions. Similarly, changes in consumer tastes, which affect demand, and technology, which affect supply, are difficult to forecast, yet one of the keys to business success is making superior estimates of these fundamentals.[25] Taxing away gains to those who more accurately anticipate consumer demand creates serious adverse incentives for entrepreneurship.

On the other hand, the government on rare occasions may truly surprise virtually everyone with a sudden change in the tax code. Similarly, changes in the fundamentals determining supply and demand may come completely out of the blue and catch even the most meticulous planners off guard.[26] In such cases, windfall capture has the benefits discussed above and yet creates little disincentive for effort or enterprise. While usually it is easy to determine that somebody earned a gain, windfalls are much more difficult to identify. Working in the gray region between obvious windfalls and obvious earnings is costly for two reasons. First, there is the simple administrative cost of making the determination, and, second, trying to draw too fine a line is likely to create disincentives for effort and enterprise. Thus, society should err on the side of defining close cases as earnings rather than windfalls.

In a democracy, ultimately the electorate will draw this line. It may be politically impossible to limit capture to true windfalls. Epstein doubts that there is "any set of social institutions that can both authorize redistribution by coercive means and then limit that redistribution to some sharply restrained and desirable level."[27] This Article argues that, in theory at least, economics provides guidelines for limiting capture and redistribution of windfalls "to some sharply restrained and desirable level."

This thesis in one sense offers a limited, less controversial version of John Rawls's theory of social justice.[28] Rawls argues that, from "behind the veil of ignorance," the distribution of individual talent is effectively random—a windfall to those with superior intelligence, physical skills, good looks, and the like.[29] Philosophically, it is difficult to contest this proposition. Who can argue that they in any sense *earned* fundamental traits

25. *See* NICHOLSON, *supra* note 15, at ch. 15 ("Market Demand") (demonstrating how individual preferences are aggregated to construct the demand curve, and discussing empirical efforts to model real-world demand curves); *id.* at ch. 7 app. ("Technical Progress") (discussing the role of technological innovation in shaping the supply curve, and analyzing hypothesized causes of technical progress).

26. The proliferation of derivative markets—in options, futures, and similar contracts for stocks, bonds, commodities, and currencies—has lowered the transaction costs of planning for an uncertain future. Such instruments, however, have not banished surprises from the course of human events.

27. Epstein, *supra* note 7, at 36.

28. *See* JOHN RAWLS, A THEORY OF JUSTICE (1971).

29. *See id.*

traceable to favorable genetics or environment? Economically, however, the point is irrelevant. No matter how random the distribution of talents at birth, significantly redistributing earnings (as opposed to windfalls) of the smart or skilled dulls their incentives to plan and work, and likely reduces social wealth. Put another way, Rawls attempts to articulate a theory of *justice*. This Article limits itself to less controversial efficiency grounds for capturing windfalls. That said, redistributionary notions of justice do provide additional grounds to support this Article's defense of windfall capture as sound social policy.

While leading to fewer recommendations for windfall capture than Rawls, this Article is more optimistic than the other polar position, which in effect argues that the costs of capturing windfalls always exceed the benefits.[30] Moreover, imperfections in democratic politics may well produce suboptimal amounts of reverse insurance. While concentrated groups facing losses can effectively lobby to socialize the costs of bad luck, perhaps leading to excessive social insurance,[31] in the case of good luck, potential beneficiaries are numerous but diffuse and may be vulnerable to lobbying by the few lucky recipients of windfalls.

III. PRIVATE WINDFALLS: RARELY WINDFALLS, NEVER WORTH CAPTURE

This Part consists of a series of negative results on the possibility of capturing private windfalls in which the number of winners and losers is relatively small. It first demonstrates that, in private litigation, courts frequently find a windfall where none exists by overlooking important ways in which parties make plans (Section III.A). Granting remedies in these cases undermines incentives to engage in productive planning. Contracts are one of the most important legal planning tools available. Parties, however, cannot anticipate every contingency—indeed, they cannot even afford to try to consider most of them. Thus, when courts of necessity imply terms for parties, they may create windfalls at odds with the parties' intent if the judges fail to realize that risk-averse parties never desire implied terms that produce lottery-like results (Section III.B).

When there is no judicial error and private windfalls do indeed exist, it is often efficient to leave them uncaptured as part of overarching public policies (Section III.C). Finally, even when they serve no such ends, their

30. *See* Epstein, *supra* note 7, at 28. Epstein admits that "[i]f there were a costless way in which the consequences of bad luck could be spread across everyone in society at large . . . then most of us would pronounce ourselves better off for the change." *Id.* at 17. He goes on to argue, however, that any scheme attempting to undo the effects of bad luck is "prey to great[] institutional and practical impediments." *Id.* at 28.

31. *See id.* at 36.

private nature makes it infeasible to capture private windfalls: Trying to tax them away merely imposes transaction costs on parties as they struggle to divide a pie that must remain hidden from the government (Section III.D).

A. *Misuse of the Term Windfall: Failure To Account for Planning*

1. *Improper Ex Post Perspective*

After the fact, many gains will look like windfalls. Prospectors may seem to stumble across gold mines; investors may appear to have "lucked out" by purchasing IBM stock in 1950 or Microsoft stock in 1985; real estate speculators often look like fortuitous beneficiaries of regional population movements. Yet speculators devote considerable skill and effort to searching for gold; investors devote time to collecting information and take considerable risks; and land speculators closely study growth patterns and commit resources to assembling parcels of useful size and shape in desirable locations. Examined from an ex ante perspective that properly values planning, these are all productive activities that the law generally aims to encourage. This Subsection examines cases where courts focus only on ex post outcomes, leading to decisions that find windfalls where none exist and redistributions of property that discourage productive planning.

Consider the facts of *City of Everett v. Estate of Sumstad*.[32] The sellers of a safe knew it contained locked compartments, and their auctioneer so informed bidders.[33] After making a winning bid of $50, the buyers hired a locksmith to open the sealed compartments.[34] The locksmith found $32,207 in cash and turned the money over to the authorities. A majority of the court awarded the money to the sellers, arguing that the contract between the parties was for a safe, not for the safe's contents—that is, there was no "meeting of the minds" concerning the concealed money.[35] Under this view, the cash was a windfall to the buyers.

As the dissent noted, however, it is hard to imagine more objective indicia of intent to sell the safe, contents and all, than the sellers' knowledge, announced by the auctioneer, of the unexamined compartments.[36] The buyers introduced evidence that their bid in part reflected a gamble that a locked and unopened compartment in a safe might contain valuables.[37] They attended auctions frequently and may well have

32. 614 P.2d 1294 (Wash. Ct. App. 1980).
33. *See id.* at 1295.
34. *See id.*
35. *See id.* at 1296-97.
36. *See id.* at 1299.
37. *See id.* at 1295.

been speculators in property with potential hidden value.[38] For every item containing hidden value, they undoubtedly purchased scores of items worth nothing beyond "face value." Forcing them to surrender their winnings is no different from forcing the owner of a stock portfolio to turn in shares of the few companies that achieve spectacular results. Note that the holding in *Sumstad* will dampen bids for safes and other items with potential hidden value—thus forcing owners rather than dealers to bear (1) the risk that there is no hidden value; and (2) the cost of determining whether there is such value. This seems inefficient, since dealers are probably better risk bearers, as repeat players, and able to determine value more efficiently.[39]

More egregious outcomes result when courts ignore clear contractual terms to avoid outcomes they find unfair ex post and therefore deem windfalls. The unfairness vanishes when we focus on the ex ante bargain made by the parties. *Brunmeier v. Farmers Insurance Exchange*[40] illustrates one common scenario.[41] The plaintiffs, the family of the victim of a fatal on-the-job car accident with an uninsured motorist, collected $25,000 from the employer's workers' compensation insurer.[42] While the decedent's personal auto insurance included $10,000 in uninsured motorist coverage, the policy contained an express clause reducing uninsured motorist benefits by any amount paid under a workers' compensation policy.[43] The plaintiffs sued to collect on the decedent's personal insurance policy, claiming that the terms of the policy gave the insurer a windfall.

Bafflingly, the court declared that any way it ruled would result in a windfall. It correctly noted that if it permitted the decedent's survivors to recover on both policies, they would have reaped a windfall.[44] It incorrectly

38. *See id.* at 1297. That the buyers anticipated at least the possibility that the safe contained hidden value is central to the argument that they reaped no windfall and distinguishes *Sumstad* from the true private windfall cases examined *infra* Section III.D.

39. Note that, counterintuitively, the buyers would have an even stronger case if they *knew* that the safe contained cash. Presumably, they applied effort or skill to discover the existence of unknown resources. Such efforts, like high-tech explorations for oil, yield productive information. To encourage collection of productive information, parties possessing it are not required to disclose it to those with whom they trade. Thus, an oil company is not required to disclose its knowledge that a field contains oil when it negotiates to buy the land usually using a "straw," since the oil company's identity would tip off the present owner that his land contained oil.

There is an important caveat in the *Sumstad* case, due to the fact that the plaintiffs discovered cash as opposed to items with intrinsic value. "In the case of currency (as distinct from treasure that has historical, aesthetic, or collectors' value), the optimal level [of search] is very low, perhaps zero. Finding money does not increase the wealth of society; it just enables the finder to have more of society's goods than someone else." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 3.2 (5th ed. 1998).

40. 208 N.W.2d 860 (Minn. 1973).

41. For similar cases, see *Booth v. Seaboard Fire & Marine Insurance*, 431 F.2d 212 (8th Cir. 1970); and *Douthet v. State Farm Mutual Automobile Insurance*, 546 S.W.2d 156 (Mo. 1977).

42. *See Brunmeier*, 208 N.W.2d at 861.

43. *See id.*

44. *See id.* at 865.

reasoned, however, that judgment for the insurer would also create a windfall, reducing the insurer's liability based on the fortuitous existence of a workers' compensation policy.[45]

While at first blush this may appear to be a windfall to the insurer, a moment's reflection reveals that this is a contingency that the insurer anticipated ex ante and addressed in an explicit contractual term. It is hard to imagine a case of more thoughtful planning. Presumably the decedent paid less for personal auto coverage in return for sacrificing double coverage in those instances in which he was injured by an uninsured motorist while working. Labeling this a windfall is nonsensical; the whole point of contractual terms is to allocate risk as part of the total bargain between the parties.[46]

Courts often improperly consider leasehold assignments and sublets from an ex post perspective. A tenant who signs a multiyear lease at a fixed rent will have a valuable asset if rents rise. Absent contractual language to the contrary, tenants may assign or sublet the premises freely and charge rent in excess of what they are paying to the owner.[47] Landlords often include lease provisions abrogating this default rule, giving them an unqualified right to reject sublets or assignments.

Courts display a strong tendency to imply qualifications to a landlord's right of refusal; they fear that free exercise of this right allows landlords to reap windfalls. Courts often uphold a landlord's right to reject assignees or sublettees when they have "commercially reasonable" objections,[48] such as "financial responsibility of the proposed assignee; suitability of the use for the particular property; legality of the proposed use; need for alteration of the premises; and nature of the occupancy, i.e., office, factory, clinic, etc."[49] Otherwise, they deem it unreasonable "to deny consent in order that the landlord may charge a higher rent than originally contracted for."[50]

Letting a landlord charge a higher rent before a leasehold ends, due to the seeming fortuity of a tenant's desire to assign or sublet, is a windfall in the eyes of the courts.

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45. *See id.*

46. Although the court claimed that the statute governing workmens' compensation insurance supports its result, it failed to apply portions of the statute that explicitly permitted insureds to contract for as much or as little uninsured motorist coverage as desired: "The named insured shall have the right to reject in writing [uninsured motorist coverage] .... [A]t the option of the insured, the uninsured motorist limits shall be equal to those provided in the policy of bodily injury liability insurance of the insured or such lesser limits as the insured elects to carry." *Id.* at 862 n.1.

47. *See* RICHARD R. POWELL & PATRICK J. ROHAN, POWELL ON REAL PROPERTY ¶ 246 (abridged ed. 1968).

48. Kendall v. Ernest Pestana, Inc., 709 P.2d 837, 841 (Cal. 1985).

49. *Id.* at 845 (citations and internal quotation marks omitted).

50. *Id.* (citations and internal quotation marks omitted).

> This is because the lessor's desire for a better bargain than contracted for has nothing to do with the permissible purposes of the restraint on alienation—to protect the lessor's interest in the preservation of the property and the performance of the lease covenants. [T]he clause is for the protection of the landlord in its ownership and operation of the particular property—not for its general economic protection . . . [The landlord] here is trying to get more than it bargained for in the lease.[51]

The courts' assumption that landlords include anti-assignment clauses solely to screen for solvent and appropriate tenants seems unwarranted.[52] Rent terms are central to any lease, and it is entirely possible that landlords include anti-assignment clauses both to screen tenants *and* to reap the benefit of rising rents should the tenant desire to exit early. Tenants presumably pay lower rent in return for giving up their right to take advantage of rising rents.

By assumption, courts are inferring the unrevealed intent of the parties, an admittedly imprecise undertaking. In this context, however, there are good reasons to believe that landlords, often larger entities with diversified real estate portfolios, are in a better position to bear the risk of fluctuating rents. Landlords may do statistical analyses to figure how many tenants are likely to exit early, and how early they are likely to exit. Thus, both the terms of leases and the nature of typical parties to a lease suggest that landlords do not reap windfalls when they refuse to permit assignment of a leasehold so that they can raise the rent. By planning for such contingencies and factoring them into the rents they charge, landlords provide benefits to tenants as well as themselves.[53]

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51. *Id.* (citations and internal quotation marks omitted); *see also* Warner v. Konover, 553 A.2d 1138 (Conn. 1989) (holding that a landlord cannot unreasonably withhold consent for a sublease); Jack Frost Sales v. Harris Trust & Sav. Bank, 433 N.E.2d 941 (Ill. App. Ct. 1982) (same); Julian v. Christopher, 575 A.2d 735 (Md. 1990) (same). *See generally* POWELL & ROHAN, *supra* note 47, ¶ 17.04[1][b] (describing tenants' broad rights to assign and sublet).

52. Courts are not alone in making this unwarranted assumption; a leading treatise states that anti-assignment clauses "are justified as reasonable protection of the interests of the lessor as to who shall possess and manage property in which he has a reversionary interest and from which he is deriving income." ROBERT S. SCHOSHINSKI, AMERICAN LAW OF LANDLORD AND TENANT § 8.15, at 578-79 (1980); *see also* POWELL & ROHAN, *supra* note 47, ¶ 246 (suggesting that landlords' rights to limit assignment or subletting be limited to substantive objections to the proposed new tenant).

There may be rational grounds to impose a clear-statement rule requiring landlords to be exceptionally forthright and explicit about an unqualified right to reject sublets or assignments. Since they are generally better informed than tenants about the real estate market, the likelihood of early exit, and other relevant facts, clear-statement rules may be a sensible way of prodding landlords to share their knowledge with tenants. *See generally* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (explicating the theory that default contract rules encouraging more knowledgeable parties to reveal information are efficient).

53. Another misidentified windfall almost exactly analogous to lease anti-assignment clauses came up in judicial treatment of mortgage due-on-sale clauses that effectively prevent a home

The way parties deal with the major uncertainties surrounding litigation often confuses courts and gives rise to another class of cases in which courts find windfalls where none exist. Two similar cases reaching opposite outcomes illustrate this type of error. The essential facts of *Thick v. Lapeer Metal Products*[54] and *Squibb & Sons, Inc. v. Accident & Casualty Insurance*[55] are the same: A plaintiff had potential claims against two insurers. It was possible that neither insured company was liable, that only one of them was liable, or that both were liable. In both cases, one insurer (label it I_S) decided to settle while another (label it I_{NS}) decided not to settle and proceeded to trial,[56] and both cases resulted in judgments holding that I_{NS} alone was liable for the plaintiff's injuries. I_{NS} in both cases maintained that the court should deduct the amount I_S paid the plaintiff (as a settlement) from the damages due.

The *Lapeer Metal* court agreed and permitted I_{NS} to deduct I_S's settlement payment from damages, citing "the primacy of the policy against double recovery .... 'To preclude credits would allow claimants to receive windfalls.'"[57] The dissent clearly explains why, looking at the case from the proper ex ante perspective—given that settlement is obviously a method to manage uncertainty in litigation—there was no windfall:

> "*At the time the redemption agreement was entered into* ... both insurers ... were *potentially* liable. [I_S] entered into the redemption agreement to relieve its potential liability. The fact that the [court] ... found ... no liability on the part of [I_S] should not

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buyer from taking over the seller's mortgage. In the rising-interest-rate environment of the late 1970s, courts in a number of states read in a reasonableness requirement and refused to enforce the clauses. *See, e.g.*, Wellenkamp v. Bank of Am., 582 P.2d 970 (Cal. 1978). The courts found it unreasonable for lenders to be able to charge higher interest rates simply because a homeowner decided to move. As with anti-assignment clauses, however, there is reason to believe that at least part of the reason lenders inserted such terms was precisely to provide themselves with some protection if and when rates rose. Like landlords, lenders, as players with large pools of loans, seem in a better position than homeowners to calculate borrowers' average tenure in a given home and thus manage the risk of fluctuating interest rates. Homeowners are likely better off accepting lower interest rates and putting all the interest rate risk—upside and downside, given the homeowner's right to prepay—on the lender.

Congress eventually preempted state law and mandated the validity of due-on-sale clauses in the Garn-St. Germain Act, Pub. L. No. 97-230, § 341, 96 Stat. 1469, 1505 (1982) (codified as amended at 12 U.S.C. § 1701j-3 (1994)). For a detailed history of this episode, see GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 5.21-5.24 (3d ed. 1994).

54. 353 N.W.2d 464 (Mich. 1984).

55. No. 92 CIV. 7327(JSM), 1997 WL 251548, at *1 (S.D.N.Y. May 13, 1997).

56. In *Squibb*, there were actually multiple insurers settling and not settling, but that does not affect the analysis.

57. *Lapeer Metal*, 353 N.W.2d at 467 (quoting Stanley v. Hinchcliffe & Kenner, 238 N.W.2d 13 (Mich. 1976)).

> negate the parties' understanding that the . . . settlement was in settlement of [I_S's] *potential* liability."[58]

The *Squibb* court agreed with the reasoning of the dissent in *Lapeer Metal.* Emphasizing the need to focus on the parties' decisions under pretrial uncertainty, it refused to order the plaintiff to pay I_{NS} the settlement payment from I_S that

> *in hindsight* turned out to be in excess of their legal obligation. . . . [The plaintiff], in settling with [I_S], took something less than it might have recovered had it litigated to the end against the settling insurers and ran the risk that the amount it received in those settlements would be less than it was ultimately obligated to pay.[59]

As the court in *Squibb* and a separate concurrence in *Lapeer Metal* note, the decision to permit deduction of the settlement payment amounts to a windfall for I_{NS}.[60] Worse, the *Lapeer* decision is inefficient in two respects. Both courts noticed the first: Allowing nonsettling parties to deduct settlement payments creates a disincentive to settle.[61] Second, the *Lapeer* court's decision results in underdeterrence: Parties like those insured by I_{NS} will not bear the full cost of the damages they inflict, and therefore, they are likely to take less than optimal levels of precaution. Thus, the *Squibb* court refused to deprive a claimant of a fairly-struck bargain that, ex post, translated into a double recovery.[62]

58. *Id.* at 469 (Kavanagh, J., dissenting) (emphases added) (quoting Thick v. Lapeer Metal Products, 302 N.W.2d 902 (Mich. Ct. App. 1981)).

59. *Squibb*, 1997 WL 251548, at *2; *see also* Maryland Casualty v. W.R. Grace & Co., No. 99 CIV. 2613(JSM), 1996 WL 109068 (S.D.N.Y. Mar. 12, 1996) (holding that a liable nonsettling insurer could not deduct the payment made by a settling insurer).

60. *Squibb*, 1997 WL 251548, at *2; *Lapeer Metal*, 353 N.W.2d at 468-69 (Williams, C.J., concurring).

61. *Squibb*, 1997 WL 251548, at *3; *Lapeer Metal*, 353 N.W.2d at 467-68. It does seem that the parties could contract around this disincentive to settle. Assuming that the plaintiff is risk-averse, it would be sensible for I_S to offer more up front in return for a promise from the plaintiff to refund part or all of the settlement if and when the plaintiff obtains a judgment against I_{NS}. The plaintiff could thus "lock in" a fixed amount, while the settling insurer (instead of the plaintiff) would bear a portion of the risk of the litigation with I_{NS}.

62. Other cases have correctly rejected windfall arguments made by parties in the context of litigation uncertainty. *See, e.g.*, Beecher v. Able, 441 F. Supp. 426 (S.D.N.Y. 1977) (rejecting an argument that unexpectedly low claims filed in a class action should lead to an ex post reduction of the settlement amount). *But see* Nelson v. Taff, 499 N.W.2d 685, 690 (Gartzke, J., concurring) (Wis. Ct. App. 1993) (arguing erroneously that a bankrupt plaintiff obtained a windfall by settling a claim with the trustee for cents on the dollar and then later recovering the entire claim plus punitives from the responsible third party); *id.* at 692 (Sundby, J., dissenting) (same).

2. *Ignoring the Shadow That Law Casts over Bargaining*

People often arrange their contracts and other affairs with one eye on the legal environment in which they live. When courts lose sight of this sort of planning, they erroneously label as windfalls gains earned by prudent planning. Such holdings, like those examined in the previous Section, undermine incentives to engage in the eminently productive activity of planning one's affairs in compliance with the law.

Sometimes the errors are facile, yet buried in the twists and turns of complex fact patterns. In *Ink v. City of Canton*,[63] for example, the state condemned large portions of a public park that reverted to the grantor or his heirs if the city ever stopped using the land as a park. The court had to decide how to apportion the just compensation proceeds between the heirs (Ink) and the city (Canton).

The court drew a distinction between sales and gifts, reasoning that purchasers should receive the entire eminent domain award, while donees should receive only the value of the land as restricted, with the remainder going to the donor.[64] The latter rule, for gifts, may make sense based on reasonable inferences about the donor's intent: Electing to place restrictions on donated land evidences that the donor attached some value to the restriction. Although the donor here, as in many cases, may not have anticipated condemnation and thus did not insert a term to deal with such a contingency, it seems reasonable to infer that most donors would prefer the return of value they never donated.

The court's rule for sales, giving the buyer the entire eminent domain award, however, is obviously erroneous. The court went astray when it reasoned that "where the grantee paid the grantor the full value of the property for the determinable fee . . . giving the grantor any part of the eminent domain award would represent a windfall to the grantor."[65] The error is obvious: Who would pay "full value" for a restricted (determinable) fee? Buyers of restricted fees pay lower prices, and hence the court's rule results in windfalls to them, not to sellers. Whether acquired by sale or gift, the owner of a defeasible fee received something clearly of less than full (unrestricted) value. By incorrectly assuming that a purchaser would pay full value for a restricted fee, the court erroneously worries that giving any part of an eminent domain award to the grantor amounts to a windfall.

Whether conveyed by sale or by gift, we must presume that the restriction itself had utility to the grantor such that he preferred the land

63. 212 N.E.2d 574 (Ohio 1965).
64. *See id.* at 577.
65. *Id.*

restricted to selling at a higher market price. The gift/sale distinction merely tells us implicitly what the grantor wished to do with the value embodied in the restriction: receive fair value himself or donate the same value to charity. If and when the state condemns a restricted fee, the grantee, or his heirs or assigns, should receive only the value of the land as restricted, whether he bought the land or received it as a gift. To give a grantee the full value of the land, as the court advises, creates a real windfall for the grantee by avoiding an illusory windfall to the grantor.

One of the precepts for the *Ink* decision was a previous holding that despite any use restrictions, the state must pay just compensation equal to market value as if the land were not restricted.[66] Ironically, this earlier case, *Thormyer*, correctly addressed a windfall issue quite similar to the one mishandled in *Ink*. The *Thormyer* court noted that it would be a windfall to the state if it could acquire land more cheaply by the happenstance of private use restrictions. The court at first suggested that the landowner would receive a windfall if just compensation paid her a price undiscounted for restrictions on her use. In deciding to force the state to pay full market value, however, the court zeroed in on the relevant source for its rule: the intent of the grantor.

> It cannot be seriously suggested that, if he had foreseen that appropriation by the state, he would have wanted the state to benefit from the restriction by being enabled to take the land for less than it was worth. To give such an effect to the restriction would be to completely ignore and distort the purpose of the donor. The purpose he disclosed by his gift clearly indicates that, if he had foreseen the appropriation, his intention would have been that the restriction be eliminated in any determination as to what should be made available by the state to replace the benefits he had provided for those whom he intended to benefit, i.e., the occupants of the county children's home.[67]

Thus, the court was in effect doing no more than implying terms in the grant to address contingencies that the grantor did not address explicitly.

Other incorrect findings of windfalls, such as the major justification for the contemporaneous ownership requirement (COR) for derivative corporate law suits,[68] are rooted in circular logic that fails to realize the law's role in private decisionmaking. The COR bars those who obtain

66. *See id.* (citing Board of County Comm'rs v. Thormyer (*In re* Appropriation of Easement for Highway Purposes), 159 N.E.2d 612, 619 (Ohio 1959)).

67. *Thormyer*, 159 N.E.2d at 618.

68. A derivative suit is "[a] suit by a shareholder to enforce a corporate cause of action." BLACK'S LAW DICTIONARY 443 (6th ed. 1990). Shareholders bringing derivative actions believe the corporation has suffered an injury for which the officers in control, for one reason or another, will not initiate suit.

shares after the purported wrong against the corporation from instituting a derivative suit; only owners who held shares at the time of the harm may sue on the corporation's behalf. Thus, the COR prevents the right to sue from "running with the shares"—a transfer extinguishes the power to bring a derivative suit.[69]

In defending the COR, many courts reason that permitting buyers to sue will result in a windfall: Investors will buy at a discount, reflecting the corporation's reduced value due to the harm that gives rise to a suit, and then restore the full value of the shares by a successful derivative suit.[70] In the absence of the COR, however, shares of corporations suffering remediable harms would not sell at as much of a discount—any discount would reflect only uncertainty about success on the merits of the derivative suit. If the corporation was sure to win, buyers would bid up the price to reflect the value of the firm including future recovery for whatever harm was done.[71] Like the rationale in *Ink*, the idea that allowing later purchasers of shares to sue for prepurchase harms can create windfalls rests on an erroneous notion of how parties will strike bargains given legal rules. Moreover, it is generally efficient to allow parties to transfer assets. In this particular case, shareholders averse to litigation risk wish to sell, and others wish to buy, shares with the right to sue attached.

A similar fallacy occurs when courts refuse to permit sellers with valid inverse condemnation suits to sell the right to sue along with the property.[72] If a new statute, ordinance, or administrative rule amounts to a taking, the owner of the land at the time of enactment undoubtedly can bring an inverse condemnation suit. Courts are split, however, on whether a

69. *See* 13 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5981 (perm. ed. 1995).

70. *See* Bangor Punta Operations v. Bangor & Aroostook R.R., 417 U.S. 703 (1974); El Dorado Bancshares v. Martin, 701 F. Supp. 1515, 1519 n.3 (D. Kan. 1988) ("[T]he determination of whether shareholders can recover rests primarily on whether such a recovery would result in a windfall. . . ."); Courtland Manor, Inc. v. Leeds, 347 A.2d 144 (Del. Ch. 1975); Home Fire Ins. v. Barber, 93 N.W. 1024 (Neb. 1903).

71. As long as a suit is possible, "[a]n element of the purchase price paid [would] be attributable to the per share value of the possible corporate recovery." Paul P. Harbrecht, *The Contemporaneous Ownership Rule in Shareholders' Derivative Suits*, 25 UCLA L. REV. 1041, 1062 (1978). Similar reasoning leads Dean Clark to conclude that "it is difficult to justify the continued existence of the contemporaneous ownership rule." ROBERT CHARLES CLARK, CORPORATE LAW § 15.4, at 651 (1986).

72. Inverse condemnation refers to a suit by a landowner claiming that the state has taken some action so intrusive that it amounts to expropriation. Since the state has not filed a direct condemnation suit in order to take title and determine just compensation, the landowner may file an inverse condemnation suit, asking a court to (1) rule that there has been a taking; and (2) determine just compensation and order the state to make payment. *See* POWELL & ROHAN, *supra* note 47, § 79B.03; 2A JULIUS L. SACKMAN, NICHOLS ON EMINENT DOMAIN § 6.14 (rev. 3d ed. 1998).

subsequent purchaser may bring the same suit—that is, on whether the inverse condemnation suit "runs with the land."[73]

Some courts refuse to permit subsequent purchasers to sue, arguing that such buyers, like purchasers of shares in companies that may have a right to sue, will buy cheaply based on the restrictive effects of the new law and then realize the unrestricted value of the land by successfully bringing an inverse condemnation suit. "Any compensation received by a subsequent owner for enforcement of the very restriction that served to abate the purchase price would amount to a windfall, and a rule tolerating that situation would reward land speculation to the detriment of the public fisc."[74]

This reasoning is deeply flawed. If buyers know the rule barring suit, they will pay a reduced price reflecting the lower value of heavily regulated land. Conversely, if buyers know that they may sue, they will bid up the price closer to the full value of the land, possibly discounted for the cost and risk of the necessary lawsuit. Windfalls will exist only when the courts surprise the parties. If a buyer purchases when the general opinion is that suits do not run with the land and subsequently convinces courts to alter the rule, then the buyer arguably receives a windfall.[75] As long as legal rules are

73. For examples of cases holding that a subsequent purchaser may sue, see *Lopes v. City of Peabody*, 629 N.E.2d 1312 (Mass. 1994); and *Moroney v. Mayor and Council of Old Tappan*, 633 A.2d 1045 (N.J. Super. Ct. App. Div. 1993). For a general discussion and collection of cases, see Stephen E. Abraham, *Windfalls or Windmills: The Right of a Property Owner To Challenge Land Use Regulations (A Call To Critically Reexamine the Meaning of* Lucas), 13 J. LAND USE & ENVTL. L. 161 (1997).

74. Anello v. Zoning Bd. of Appeals, 678 N.E.2d 870, 871 (N.Y. 1997). In a similar decision issued simultaneously, the same court argued that a buyer's "reasonable expectations were reflected by his consideration of the inherent limitations on the property when he made the purchase offer for thousands less than its worth without the restrictions." Gazza v. New York State Dep't of Envtl. Conservation, 679 N.E.2d 1035, 1043 (N.Y. 1997).

75. As with derivative suits and the contemporaneous ownership rule, efficiency considerations weigh strongly in favor of permitting inverse condemnation suits to run with the land. Alienability allows the party who most highly values the package of land and lawsuit to obtain the assets. Some courts that permit subsequent buyers to bring inverse condemnation suits explicitly discuss such efficiency concerns. *See Lopes*, 629 N.E.2d at 1315 (arguing that barring purchasers from bringing inverse condemnation suits "would threaten the free transferability of real estate"). Massachusetts law may be less friendly to subsequent buyers after *Leonard v. Town of Brimfield*, 666 N.E.2d 1300 (Mass. 1996).

The rules against suits by subsequent purchasers of shares or land are highly formalistic and hence manipulable. If the rule barring subsequent buyers from suing became sufficiently inconvenient, owners of shares or land could place their assets in a shell corporation. Instead of selling the underlying asset, they could sell all shares of the shell corporation. The shell corporation, not the underlying buyer, would (formally) own any cause of action; as a legal person in existence at the time of the wrong to the corporation or the offending statute, the corporation would have the indisputable right to sue no matter how many times the shares or land effectively changed hands. This use of formalism to circumvent rules extinguishing lawsuits when lands change hands rests on the universal power of corporations, as legal entities distinct from their shareholders, to hold title to real property. *See, e.g.*, DEL. CODE ANN. tit. 8, § 122(4) (1991 & Supp. 1998); MODEL BUS. CORP. ACT ANN. § 3.02(4) (1984).

predictable, prudent planning that accounts for those rules cannot lead to windfalls.

B. *Inefficient Enrichment: Avoiding Contract Interpretations That Create Unintended Windfalls*

Even the most prudently drafted contracts cannot cover all, or even most, contingencies; there are simply too many variables in the world. Thus, one of the primary purposes of contract law is to infer the likely intent of the parties when confronted with circumstances not governed by explicit contractual terms. Unjust enrichment and quasi-contract cases take this tool to its limit, implying the very existence of contracts where none exist. As the label "unjust enrichment" indicates, courts generally justify implying contract-like obligations to prevent one party from reaping a windfall at the expense of the other—indeed, courts often use the phrase "windfall" as a synonym for "unjust enrichment."

This Section first summarizes existing work demonstrating that unjust enrichment cases are appropriately decided on efficiency grounds: Courts imply contracts when transaction costs are prohibitive but circumstances make it likely that the parties would have struck a deal if they could have bargained. It then examines a new class of cases in which courts should, and often do, imply contractual terms: Assuming parties are risk-averse, they would not desire provisions that lead to lottery-like outcomes where one party gains at the expense of the other via a surprise. By implying terms that avoid such results, courts enable parties to economize on the expensive process of drafting detailed contracts. Finally, it shows that the same reasoning supports rescissory remedies for contractual mistake, frustration, or impossibility.

The law of restitution in general, and unjust enrichment in particular, focuses on situations in which it is feasible to force recipients to cough up unearned windfalls. "Restitution occupies the crucial ground between its much-studied neighbors, tort and contract. Restitution deals with nonbargained benefits; tort law with nonbargained harms; contract law with bargained benefits and harms."[76] The universe of "nonbargained benefits" covered by unjust enrichment alone, merely one branch of the law of restitution, has always been a bit of a motley collection seemingly without a unifying theme; it includes everything from provision of unsolicited services to mistaken overpayments to contractual restitution for frustration, impossibility or illegality.[77]

76. Saul Levmore, *Explaining Restitution*, 71 VA. L. REV. 65, 67 (1985).

77. For the most extensive survey of the field, see GEORGE E. PALMER, THE LAW OF RESTITUTION (1978).

Courts deciding unjust enrichment cases often deem an unbargained-for benefit a windfall to justify ordering restitution. While the very label and most doctrinal analysis emphasize issues of fairness in deciding unjust enrichment cases, efficiency provides a powerful prescription for how courts should, and do, decide these cases.[78] Under this reading of the cases, the doctrine should be labeled *inefficient* enrichment, not unjust enrichment.

The key variable is transaction costs. If it is inexpensive for parties to bargain, then they are expected to do so, and the law will not imply a contract when, for example, a violinist plays under a stranger's window and demands payment after the last note,[79] when a neighbor asks for payment after installing a water purification system in a common well,[80] or when someone washes your windshield at a red light and requests payment when finished.[81] While the recipient in each case receives a windfall,[82] the law effectively warns the provider that since low transaction costs make bargaining feasible, the law will not imply contract-like obligations to pay for services rendered.

When transaction costs are high, however, it is often sensible for the court to imply the existence of a contract. When a doctor provides services to an unconscious person on the street, for example, bargaining is literally impossible.[83] On the presumption that most people would request aid if they could, courts will give the doctor the legal right to collect a fee, often under the rubric of quasi-contract.[84] Transaction costs may be high for many reasons. If one ship happens across a sinking vessel, the two are in a bilateral monopoly and may fight over the price of rescue, especially if the value of the cargo in the sinking ship is much higher than the risk-adjusted cost of rescue. Thus, the law of the sea implies a contract: Rescuers receive the fair market value of their salvage services.[85] When transaction costs are high due to the large number of parties, we have a public windfall, discussed *infra* Part IV.

There is another sense in which transaction costs are always potentially high: It is futile to draft contracts that explicitly anticipate every contingency, and trying to do so is expensive. Modern contract scholarship

78. *See* POSNER, *supra* note 39, § 4.13.

79. *See id.*

80. *See* Levmore, *supra* note 76, at 71.

81. *See* Richard A. Epstein, *The Ubiquity of the Benefit Principle*, 67 S. CAL. L. REV. 1369, 1380 (1994).

82. Of course, one only receives a windfall if the music was enjoyable, the purification system actually worked, and the windshield became cleaner as a result of the squeegee person's efforts.

83. *See* POSNER, *supra* note 39, § 4.13.

84. *See* Cotnam v. Wisdom, 104 S.W. 164 (Ark. 1907); *In re* Estate of Crisan, 107 N.W.2d 907 (Mich. 1961); Landmark Med. Ctr. v. Gauthier, 635 A.2d 1145, 1148 (R.I. 1994); RESTATEMENT OF RESTITUTION § 116 (1937).

85. *See* 3A BENEDICT ON ADMIRALTY §§ 1-4 & 232-44 (Martin J. Norris ed., 7th ed. 1997).

emphasizes the important role the law plays in constructing a large body of default terms that govern parties in the absence of specific contractual provisions.[86] The goal is to make contracting cheap by minimizing the amount of dickering and drafting parties need to undertake.

Courts choose default rules that they believe the parties would have chosen had they anticipated an unanticipated event. While this is often difficult, widely held assumptions about risk preferences provide the basis for strong presumptions about the likely intent of the parties. One of the most frequently cited grounds for allocating a given risk is to determine which party was in a better position to manage the risk, either by exercising caution or by obtaining some sort of insurance coverage. Another risk-allocation argument explains many unjust (inefficient) enrichment cases where courts order restitution of a windfall: Courts assume that parties are risk-averse and thus would not insert terms that in effect create a private lottery between them.

One example comes from frequently litigated questions on the effect of a death on survivorship rights in commonly held property during the pendency of a divorce or after divorce when the final decree is ambiguous.[87] In the prototypical case, Husband and Wife (*H* & *W*) own their home as joint tenants or tenants by the entireties. In either case, a surviving spouse takes sole title if the other dies before dissolution of the cotenancy.[88] Their divorce settlement calls for a sale of the house and division of the proceeds, but *W* dies before a court finalizes the divorce. Under a formal approach, the marital tenancy has not yet dissolved, the divorce settlement is not yet final, and thus *H* would walk away with the house despite his deceased wife's wishes (as manifested in her will) to leave all her worldly goods to her sister. Many courts decide these cases on precisely such formalistic grounds.[89]

86. *See generally* Ayres & Gertner, *supra* note 52 (discussing default rules); Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977) (analyzing impossibility, impracticability, and frustration).

87. The frequency with which such cases are litigated is not necessarily tied to the stress of divorce and resulting deaths during the (usually) relatively short period between initial filing and final divorce decree, but because in some cases the divorce proceedings drag on for years, *see, e.g., In re* Violi, 482 N.E.2d 29 (N.Y. 1985), discussed *infra* note 89, or the final decree does not resolve clearly the status of jointly held property.

88. *See* POWELL & ROHAN, *supra* note 47, ¶ 617 (discussing survivorship rights among joint tenants); id. ¶ 624 (discussing survivorship rights between tenants by entireties).

89. For a typical example of this formal approach, see *Violi*, 482 N.E.2d 29, in which the court awarded a house held by the entireties to the husband after the wife died. While the couple had a divorce agreement calling for division of the value of the house, they remained separated for years without legally dissolving their marriage. Thus the divorce agreement was never executed.

In addition to relying on the formality that the tenancy by the entireties had never terminated, the court said that its holding rested in part on a "public policy favoring certainty in title to real property." *Id.* at 32. While certainty of title would be relevant if a third party were involved, the dissent points out that it has nothing to do with a dispute between co-owners.

It seems very unlikely that the parties would desire a provision that in effect gambled on deaths during the "executory" period before finalization of the divorce.[90] Under the formal approach, parties to an unfinalized or ambiguous divorce agreement obtain the opportunity for a windfall, if their spouse dies first, but pay via a symmetric risk of a wipeout: Their heirs receive nothing if they die first. The formal rule introduces significant risk where there need be none. It seems quite likely that, were the parties to a divorce agreement to contemplate the possibility of an unexpected death, they would include a term dissolving the joint interest immediately. This would assure both sides (and their heirs) of receiving negotiated shares of the property. And in what one litigant characterized as "a developing modern trend,"[91] many courts are looking past formalism to the likely desires of the divorcing couple. In *Sondin v. Bernstein*, for instance, a couple continued to occupy different portions of the property after divorce.[92] The settlement did, however, call for division of the proceeds should the divorcees ever decide to sell the entire building.[93] The court admitted that the divorce settlement had not formally severed the spouses' joint tenancy, but held that by contract—the divorce settlement—the deceased husband's estate was nonetheless entitled to half the proceeds of a sale.[94]

Gordon v. Mazur[95] illustrates another context in which a court dispensed with formalism and focused on the probable intent of the parties in order to avoid a windfall that the parties likely never intended ex ante. Co-owners of a building contracted for mutual rights of first refusal to buy

> [The divorcing couple, *H* and *W*,] made clear their intent that the tenancy by entirety between them be no longer continued and, the present contest being over whether [*H*] should receive a windfall to the exclusion of [*W*'s] heirs, no public policy with respect to the protection of bona fide purchasers should play any part in our determination.

Id. at 33 (Meyer, J., dissenting). For other decisions following the formalist approach despite evidence of the parties' intent to the contrary, see *Kirven v. Reynolds*, 536 So.2d 936 (Ala. 1988); *Jones v. Earnest*, 819 S.W.2d 280 (Ark. 1991); *Bruce v. Dyer*, 524 A.2d 777 (Md. 1987); *Pavluvcik v. Sullivan*, 495 N.E.2d 869 (Mass. App. Ct. 1986); *In re Estate of Sander*, 806 P.2d 545 (Mont. 1991); *Shutt v. Butner*, 303 S.E.2d 399 (N.C. Ct. App. 1983); and *In re Marriage of Lutzke*, 361 N.W.2d 640 (Wis. 1985).

90. Indeed, one way to recharacterize the formal approach is to analogize each spouse's contingent right to obtain sole title as a strange sort of life insurance on the other. This immediately raises an important question: Do separated or divorced spouses, still tied by an undissolved joint ownership interest, have an insurable interest in each other's lives? The law takes a dim view of those wishing to take out life insurance on those with whom they have no familial or economic ties. *See* 3 GEORGE J. COUCH, COUCH ON INSURANCE 3D § 41:1-:10, :17-:24 (Lee R. Russ & Thomas F. Segalla eds., 1997 & Supp. 1998) (describing the legal requirements of an insurable interest).

91. Sondin v. Bernstein, 467 N.E.2d 926, 929 (Ill. App. Ct. 1984).

92. *See id.* at 928.

93. *See id.*

94. For other cases dividing proceeds after one spouse died despite the formal existence of a tenancy with survivorship rights, see *Wardlow v. Pozzi*, 338 P.2d 564 (Cal. App. Ct. 1959); and *Mann v. Bradley*, 535 P.2d 213 (Colo. 1975).

95. 131 N.Y.S.2d 261 (App. Div. 1954).

the other's interest at cost should one of them desire to "sell, transfer or assign" his or her interest.[96] After the value of the building apparently had appreciated, the defendant placed her interest in trust for a grandchild. The court admitted that as a matter of law, she had undertaken a "sale, transfer or assignment."[97]

The Court nonetheless decided the case for the defendant on equitable grounds, refusing to grant the plaintiff's request for specific performance. Given the appreciated value of the building, the court found that the defendant had made a mistake—she had not intended to invoke her co-owner's right to purchase at cost.

> While such a mistake might not avail the defendants in an action for damages at law, it will not foreclose inquiry by a court of equity into the justice of bestowing a windfall on one party because the other party misconstrued the technical provisions of their contract.... If [the defendant] is restored to her former status as a co-owner the plaintiff will lose nothing but an uncontemplated opportunity to gather in a windfall.[98]

The court felt justified in describing the plaintiff's potential gain as "uncontemplated" because it found, apparently without objection by either party, that they created mutual rights of first refusal to protect against being forced into co-ownership with someone who might prove troublesome. In fact, the trustee for the defendant's grandchild was the lawyer used by both parties to manage the property.[99] Given these facts, we might recast the court's holding more lucidly as the determination that the phrase "sale, transfer or assignment" in this particular contract really only meant a transaction that led to a stranger being involved in managing the property as a new cotenant.

The rationale behind *Mazur* is commonplace. Contract law frequently implies reasonable rules to avoid unexpected results that would result from strict application of contractual language. Though a land sale contract calls for the parties to close on a given day, the law entitles either party to a reasonable delay—without empowering the other side to rescind—to overcome some difficulty, unless the contract explicitly makes time "of the

96. *Id.*

97. *Id.*

98. *Id.* at 265-66. The court also found it significant that the plaintiff knew of the defendant's plan to place her interest in trust but did not invoke his right of first refusal until after she had made the transfer. *See id.* at 264-65.

It is somewhat disturbing, and seemingly inconsistent with the reasoning of the opinion, that the plaintiff could recover damages. Perhaps the court could think of nothing better than the law/equity distinction as a basis to rule for the defendant. The remaining discussion of the case suggests an alternative reading that would preclude legal as well as equitable relief.

99. *See id.* at 264.

essence."[100] The Uniform Commercial Code permits a supplier reasonably to alter performance if the contractual mode of delivery becomes impractical.[101] Such rules make sense for risk-averse parties and avoid holdup problems ex post. They also save parties the trouble of inserting boilerplate reasonable terms into every contract drafted.

Courts also apply unjust enrichment to cases of mistake. When, for instance, *A* pays *B*'s electricity bill by accident, *B* must make restitution to *A*.[102] There are two strong efficiency reasons for this rule. First, risk-averse bill-payers prefer this rule to the alternative: a lottery in which a few receive a windfall paid for by those who put down the wrong account number on their check. Second, not requiring restitution will lead all bill-payers to take excessive precautions when they prepare their bills—such as checking the account number four times instead of twice. The extra minute spent, multiplied by thousands or millions of customers, creates great waste, and it likely exceeds the cost of requiring restitution in the few cases of mistaken payment.

More commonly, mistakes occur not between unrelated customers of a common supplier, but between parties to a contract. While the law is a bit wary of permitting one party to rescind a contract based on a unilateral error, in instances of mutual mistake the courts often permit rescission and require restitution of any benefits conferred.[103] As Andrew Kull has argued powerfully, the contract doctrines of impossibility and frustration are substantively indistinguishable from the doctrine of mistake.[104]

Most modern academic commentary and case law support the remedies of rescission and restitution in cases of mistake, impossibility, and frustration. The rationale, by now undoubtedly familiar, is that most parties would contract for such a rule, given risk aversion, if they anticipated the contingency that led to a mistake, made the contract impossible to complete, or frustrated the purpose of the agreement.[105] Kull, in an elaborate dissenting view, argues that the courts are unlikely to do a good job of reconstructing what the parties would have done ex ante, and that by implying terms courts create incentives for contracting parties to bargain carelessly and superficially, since the court will later fill in their omissions.[106] He argues that older English case law and sound policy

100. UNIF. LAND TRANSACTIONS ACT § 2-302(b)-(c) (amended 1977, 13 U.L.A. 523 (1986)); *see* POWELL & ROHAN, *supra* note 47, ¶ 881[5].

101. *See* U.C.C. § 2-614(1) (1989).

102. *See* PALMER, *supra* note 77, § 14.17(a).

103. *See* RESTATEMENT (SECOND) OF CONTRACTS § 152 (1981) (discussing mutual mistake); *id.* § 153 (discussing unilateral mistake).

104. *See* Kull, *supra* note 6, at 2-3.

105. *See* RESTATEMENT (SECOND) OF CONTRACTS, *supra* note 103, §§ 151-158 (1981) (discussing mistake rules); *id.* at §§ 261-272 (discussing impracticability and frustration rules); Posner & Rosenfield, *supra* note 86, at 117-118.

106. *See* Kull, *supra* note 6, at 38-54 ("The Trouble with 'Gap-Filling'").

support his windfall principle: In the absence of a specific contractual term specifying how to allocate a risk, let the gains and losses in cases of mistake, impossibility, or frustration lie where they fall at the time the problem arises.[107]

In arguing that many private contractual windfalls are efficient, Kull apparently believes that the mainstream view overestimates the transaction costs saved due to default rules drafted by courts or legislatures. There is strong reason to believe, however, that such savings are often significant. The main justification for ornate corporate, partnership, limited liability company, and other business organization laws is that they are collections of off-the-rack rules designed to save each new enterprise the cost of drafting a long and complex set of governance rules.[108] Just as the state saves each new business enterprise the cost of reinventing efficient rules of organization, it can help all contracting parties economize on planning costs by interpreting contracts in light of the fact that people are generally risk-averse.

C. *Efficient Windfalls: Serving Wider Social Goals*

This Section deals with what seems the simplest class of cases in which the courts correctly identify windfalls: *B* and *C* are fighting over property that would best be given to a third party (*A*) not before the court. It is often difficult or impossible (that is, expensive, perhaps prohibitively so) to identify and channel property to the "true owner" or "most deserving party." While a ruling either way would appear to be a windfall, deciding between *B* and *C* may also implicate important social policies. Such wider concerns should and often do determine the outcome between *B* and *C*; the winner prevails not because of the merits of his specific claim, but as an instrument of other state goals. If it is too expensive to channel the property to *A*, these decisions are efficient second-best outcomes.

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107. *See id.* at 5-6 (stating Kull's thesis). While it sounds like a "four corners" approach (to the extent that it looks to terms within the four corners of the contract, and no further), Kull's approach is more nuanced. Older common-law cases show that a strict four corners approach has no need for doctrines of mistake, impossibility, or frustration. *See, e.g.*, Paradine & Jane, 82 Eng. Rep. 519 (K.B. 1647) (requiring a tenant to pay rent despite eviction by an invading army). Kull, however, accepts the need for rules to deal with mistake, impossibility, and frustration. He says the need for special rules in such cases is "best explained as a judicial refusal to enforce contracts beyond their original limits. Common sense sets limits to a promise, even where contractual language does not." Kull, *supra* note 6, at 38. Kull apparently thinks that it is acceptable for courts to assume that all parties would adopt this one term, but no others, to manage risk.

108. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 14 (1995) (describing corporate law as "standard 'contracts'"); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34 (1991) ("[C]orporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.").

When *F* finds property on *L*'s land, the two often end up disputing ownership. The true owner holds superior title to *F* or *L* but is unidentified at the time of adjudication. The property will constitute a windfall to whichever party wins the case.[109] Although decisions resolving such disputes form no cohesive, consistent doctrine, the true owner is never far from the courts' attentions. Thus, the seemingly obscure rule that finders keep "lost" property while landowners keep "mislaid" property reflects concern for the true owner.[110] The idea is that owners who mislay property (for example, by putting it on a store counter instead of in their pocket) are likely to return to the location where they mislaid it, while those that simply lose property (for example, it falls out of their pocket) are much less likely to return to a specific location seeking the item.[111] Thus, landowners or finders win cases only as instruments of a policy designed to return property to its true owner.[112]

A.T. Switzer Co. v. Midwestern Construction[113] is a contract dispute analogous to such finders cases. Defendant Midwestern, a general contractor on a government project, subcontracted painting work to Switzer. It turned out that no painting was necessary, but Switzer sued to enforce the contract anyway. The court permitted the defendant to rescind based on mutual mistake. It was unreceptive to the subcontractor's argument that rescission would leave the contractor with a windfall, noting that permitting Switzer to enforce the contract symmetrically would be a windfall to the subcontractor. The basis for the decision, it seems, was minimizing administrative costs: "[I]f it is a windfall either to Midwestern on the one hand or to Switzer on the other, the court will leave the parties where it found them and will not lend its aid to shift the windfall from one party to the other."[114]

The record did not contain the contractor's bid, so it is unclear whether the government could recover. Whether the government or the contractor

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109. We assume that *F* is an invitee who "stumbled across" the property; if *F* devoted resources to unearthing the item, I argue (perhaps counterintuitively) that *L* has a stronger claim. The idea is that the law encourages *F* to proceed via a market transaction with *L* (for example, by buying the land, leasing it, or negotiating for the right to extract the valuables) rather than via trespass or exploiting a license granted for one purpose to achieve other ends.

110. *See, e.g.*, Michael v. First Chicago Corp., 487 N.E.2d 403, 409 (Ill. App Ct.. 1985); McAvoy v. Medina, 93 Mass. (11 Allen) 548 (1866).

111. *See* RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY § 14 (2d ed. 1955).

112. The rationale drawn in the text for the lost/mislaid distinction elides over much of the complexity and confusion in the cases. For a more nuanced overview of the case law, along with criticism of the purported policy grounds for the distinction, see R.H. Helmholz, *Equitable Division and the Law of Finders*, 52 FORDHAM L. REV. 313, 316-27 (1983).

113. 670 S.W.2d 69 (Mo. Ct. App. 1984).

114. Kull argues that the maxim "let the gains and losses lay where they fall" expresses the proper grounds to decide a wide variety of similar contract disputes (for example, cases of mistake, frustration, and impossibility). *See generally* Kull, *supra* note 6. I address his thesis *supra* notes 104-108 and accompanying text.

made the original mistake, the court's decision in effect preserves the property so that it is more likely that the true owner (the government) can recover funds that it would otherwise lose in a contractual error. The government dealt directly with the contractor and would more likely spot the error if the contractor could not provide an invoice from a painting subcontractor. The decision also permits the government to proceed directly against the contractor, instead of requiring it to reach a subcontractor with which it had no contractual privity.

Insurance disputes frequently give rise to assertions that policyholders are reaping windfalls in two ways. In the first, the insured has multiple coverage for the same potential casualty loss. For instance, in *Continental Oil v. American Quasar Petroleum*,[115] Quasar had the rights, under a "farmout" agreement, to drill for oil and gas on land owned by Continental. The agreement called for the parties to share "costs" without defining the term. In the course of drilling, Quasar had a blowout that cost over $2.5 million to fix. It recovered $2 million on a blowout insurance policy that covered its wells all over the world. Unsatisfied, Quasar claimed that, because blowouts were a "cost" of drilling, Continental was contractually liable for half the $2.5 million cost of repairs.[116] Quasar, in effect, claimed that Continental was a partial insurer for blowout losses.

The court agreed and held Continental liable for half the blowout expenses as a "cost" under the farmout agreement. It noted that the contract did not require Quasar to obtain blowout insurance, and the parties apparently stipulated that Continental was not liable for the antecedent premiums paid by Quasar.[117] This gave rise to an inference that the parties did not contract for Quasar to bear this risk alone. The court argued that, from the proper ex ante perspective, any recovery in excess of loss would not be a windfall for Quasar:[118] It in effect bargained with two separate entities for double coverage and presumably paid for such coverage in one way or another.

Casualty insurance exceeding losses, of course, creates perverse incentives to cause accidents rather than avoid them. This is another version of the moral-hazard problem discussed in Part II. Agreements that insure against bad outcomes erode—or, when coverage exceeds losses, invert—incentives to avoid such outcomes. Such stark examples of moral hazard are rare because insurers usually take steps to rule out the possibility of surplus coverage (for example, refusing to insure property for more than its appraised value or voiding coverage if another policy exists). Indeed, insurance law, under the indemnity principle, makes a strong presumption

115. 599 F.2d 363 (10th Cir. 1979).
116. *See id.* at 364.
117. *See id.*
118. *See id.*

against excessive recovery from multiple insurers.[119] This legal presumption seems sound: Parties buying insurance very likely prefer lower premiums with recovery limited to actual losses over higher premiums along with a chance to reap a double-recovery windfall.

Continental Oil is a case that apparently fell between the cracks of the farmout and insurance contracts. Had the insurance company known that the term "cost" in Quasar's farmout agreement with Continental included implicit blowout insurance, it would have undoubtedly reduced its exposure dollar for dollar. Quasar itself probably would have preferred such a term as long as the insurer reduced its premiums accordingly—why would a risk-averse insured pay more in return for the chance to win a blowout windfall? Similarly, why would Continental put itself at risk by creating incentives for Quasar to cause a blowout, or at least to exercise less than optimal care? The court's facile analysis of the two contracts (Quasar's farmout agreement with Continental and its insurance contract) in isolation ignores the terms that the parties would have chosen had they anticipated a blowout.

A common way insurers avoid such windfall double recoveries is via subrogation clauses that permit the insurer to bring suit against a wrongdoer whose harm led to a policyholder claim.[120] Indeed, they are perceived as so useful and desirable that the law will often imply subrogation rights when an insurance contract does not explicitly include them.[121] Insurance companies benefit by recovering from wrongdoers when economically feasible; their policyholders benefit by the lower rates they receive for agreeing to subrogation clauses.[122]

Failure to consider subrogation has led numerous courts to object to the collateral benefits rule as a windfall. Under the collateral benefits rule, which is adhered to in a majority of states,[123] a tort victim may recover from

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119. *See* ROBERT E. KEETON, CASES AND MATERIALS ON BASIC INSURANCE LAW 121 (2d ed. 1977). Keeton states:

> The "principle of indemnity" . . . is the principle that insurance is legitimately aimed at conferring a benefit that is no more than an *offset* (total or partial) for accidental loss. To be consistent with this principle, the benefit must be no greater in value than the loss suffered, though it may be less than the loss.

Id. at 121.

120. There was no wrongdoer in *Continental Oil*—well blowouts are presumably acts of God. *See Continental Oil*, 599 F.2d at 364. Thus, the insurer would need some other grounds to extract Quasar's second recovery from Continental.

121. *See* 16 COUCH, *supra* note 90, § 62:1. To serve the same ends as subrogation clauses, insurance contracts sometimes include reimbursement or repayment clauses, requiring the insured to turn over to the insurance company any legal recovery against the wrongdoer. These alternatives, however, may be less valuable than subrogation clauses since the insured must bring suit instead of the insurer, yet has little incentive to do so when she must turn over any recovery to the insurer. *See* SHAVELL, *supra* note 19, at 238-39.

122. *See* SHAVELL, *supra* note 19, at 235-37.

123. "The virtually universal rule in [America] has been to treat first-party benefits that plaintiff has received as 'collateral' to the defendant's responsibility and not relevant to tort law's

the wrongdoer, even if she has already received full compensation from her first-party insurer (a benefit collateral to the wrongdoing). In the presence of a subrogation clause or similar provision, there is in the end no double recovery: The insurer pays the insured's claim and recovers in full from the wrongdoer.

Problems arise when administrative and transaction costs make it infeasible for insurers to include or apply subrogation clauses. Then a plaintiff collecting from both an insurer and the defendant does reap a windfall. Often, however, it is an efficient windfall. Denying insured plaintiffs recovery from tortfeasors when subrogation fails would mean that some tortfeasors will never pay for the damage they do. That will lead potential injurers to take suboptimal precautions and thus to cause an excessive number of torts. Allowing double recoveries is particularly attractive when there is minimal concern that victims are inducing harms in order to reap supercompensatory windfalls.[124]

Underdeterrence is the ultimate effect of cases like *Florida Physician's Insurance Reciprocal v. Stanley*,[125] where the court allowed doctors found liable for malpractice to argue that public assistance and private charity mitigated the harm to a plaintiff child with serious physical and mental disabilities. While these collateral benefits undoubtedly did reduce the family's expenses, there seems little danger of moral hazard here: It is hard to imagine how parents could raise the odds of malpractice in the first place, and it is equally implausible that they would desire a seriously handicapped child in order to extract multiple recoveries from doctors, charities, and the public fisc. The outcome permits doctors to externalize a portion of the harm they inflict, leading to underdeterrence of medical negligence.

Ideally, the public and charitable agencies providing aid would take at least a portion of the malpractice judgment by subrogation. That was apparently the court's thinking in *Epps v. Mercy Hospital*,[126] where the plaintiff received coverage under her husband's health insurance for a work-related accident covered by workmen's compensation. The court

determination of liability or damages." MARC A. FRANKLIN & ROBERT L. RABIN, CASES AND MATERIALS ON TORT LAW AND ALTERNATIVES 676 (5th ed. 1992).

124. *Continental Oil* illustrated this moral hazard problem. *See Continental Oil*, 599 F.2d at 364. It is precisely in such cases that insurance companies are most likely to include subrogation or reimbursement clauses.

One way to deal with moral hazard and deterrence is to have the state tax away any plaintiff recovery beyond actual damages. *See* SHAVELL, *supra* note 19, at 238 n.9. I examine this decoupling solution vis-à-vis punitive damages *infra* Subsection IV.C.2 . Decoupling may not work in this context, however, since plaintiffs will simply obtain full compensation from the source available at least transaction costs—invariably their insurers—and fail to bring suit against the wrongdoer. Underdeterrence will result.

125. 452 So.2d 514 (Fla. 1984).

126. 244 N.W.2d 340 (Mich. Ct. App. 1976).

declared that a judgment either way would amount to a windfall: double recovery for the plaintiff or no liability for the insurer based on the happenstance of other insurance.[127] The court remanded the case, directing the trial court to find a way, if possible, to funnel the workmen's compensation proceeds to the health insurer.[128]

As discussed earlier, however, procedural obstacles and administrative costs may make bringing a third party before the court impossible or wasteful. More important than the occasional windfall to plaintiffs is deterring potential injurers—this is what is meant by this Section's title, "Efficient Windfalls." Courts sometimes reach this result by stating a general preference for victims over injurers if one or the other must receive a windfall. In *Ciminski v. SCI Corp.*,[129] for example, the court held that a tortfeasor could not reduce its liability by the value of medical services the victim received from the government under Medicare. "[T]he real question is not whether there is a windfall, but rather who is to get it. As between an injured plaintiff and a defendant, we have no hesitation in saying that the former is entitled to prevail."[130] To restate this rule in economic terms: Society gains more by tolerating double recoveries that serve deterrence than eliminating such windfalls at the cost of underdeterring potential tortfeasors.[131]

D. *Private Windfalls: The Reporting Problem and Transactions Costs*

Not all private windfalls, however, implicate wider social policies. Consider two famous contract cases that have tortured generations of first-year students and many of the scholars teaching them.[132] In *Wood v.*

127. *See id.* at 343. Note that in *Epps*, unlike *Brunmeier v. Farmers Insurance Exchange*, 208 N.W.2d 860 (Minn. 1973), the first-party health insurance apparently contained no clause requiring the insured to turn over any workmen's compensation recovery.

128. *See Epps*, 244 N.W.2d at 343.

129. 585 P.2d 1182 (Wash. 1978) (en banc).

130. *Id.* at 1184.

131. Again, note that in health insurance cases, there is little fear of moral hazard: People are generally unlikely to risk bodily injury in order to reap a windfall based on duplicate coverage. The windfall varies directly with the injury and hence the insured would have to risk serious harm to realize a large windfall. If feasible, Medicare should have subrogated rights against the injurer, but as discussed above, this may prove too expensive.

For another case where the court allowed an efficient double recovery out of sympathy for crime victims, see *People v. Sullivan*, 71 Cal. Rptr. 2d 440 (Cal. Ct. App. 1998), *appeal granted and opinion superseded*, 955 P.2d 448 (Cal. 1998), which held that under a statute requiring criminal convicts to pay restitution, convicts could not deduct payments from a victims' insurer. The appeals court in *Sullivan* explicitly noted that the insurer could have included subrogation rights against criminals in its policies. *See id.* at 445-46.

132. Most contemporary casebooks discuss the two cases and ask students to reconcile the seemingly irreconcilable outcomes. *See, e.g.*, JOHN P. DAWSON ET AL., CASES AND COMMENT ON CONTRACTS 621-30 (6th ed. 1993); E. ALLEN FARNSWORTH & WILLIAM F. YOUNG, CASES AND MATERIALS ON CONTRACTS 799-802 (5th ed. 1995); FRIEDRICH KESSLER ET AL., CONTRACTS: CASES AND MATERIALS 84-88, 886-98 (3d ed. 1986).

Boynton,[133] the plaintiff seller could not recover a diamond already sold that both parties had believed to be a topaz. In *Sherwood v. Walker*,[134] the plaintiff seller successfully sued to rescind a contract for a pregnant cow not yet sold that both parties believed was infertile. Professors and students have puzzled over which decision is correct and over whether there is a way to justify the seemingly contradictory outcomes.[135]

In a passing comment, Kull touched on the windfall nature of *Wood* and *Sherwood*:

> The discovery that a cow thought to be barren is with calf, or that a supposed topaz is a diamond, is a clear gain to society; but whether the property acquires its greater value in the hands of one person or another will normally be a matter of complete social indifference.[136]

To rephrase, unlike the examples in the previous Section, there are no wider social concerns—like deterrence or returning property to its true owner—over who gets the diamond or the pregnant cow. Yet, there are two reasons that society might have an interest in the allocation of the windfall.

The first reason why society is not indifferent to which party receives the pregnant cow or the diamond goes to the heart of the thesis of this Article. In unjust enrichment cases, the surprise is that property ends up in the hands of one party rather than the other; there is no surprise about their joint wealth. In *Wood* and *Sherwood*, on the other hand, the parties, considered together, experience a surprise increase in wealth—a windfall. While, as the examples just discussed illustrate, this distinction does not matter to parties fighting over the property, it is the thesis of this Article that this distinction is socially important. As outlined in Part II, windfalls present an ideal target for tax revenue and for redistribution. Although there is "complete social indifference" whether one litigant or the other receives the pregnant cow or the diamond, a third choice may be socially desirable: tax away the value of the windfall gain in each case.

Attempts to capture these private windfalls, however, are doomed to fail: A version of the reporting problem that prevents the emergence of reverse insurance for windfalls also prevents capture in cases like *Wood* and

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133. 25 N.W. 42 (Wis. 1885).

134. 33 N.W. 919 (Mich. 1887). For recent scholarly commentary on *Wood* and *Sherwood*, see David Frisch, *Buyer's Remedies and Warranty Disclaimers: The Case for Mistake and the Indeterminacy of U.C.C. Section 1-103*, 43 ARK. L. REV. 291 (1990); Hoffman F. Fuller, *Mistake and Error in the Law of Contracts*, 33 EMORY L.J. 41, 58-62 (1984); and Kenneth L. Schneyer, *The Culture of Risk: Deconstructing Mutual Mistake*, 34 AM. BUS. L.J. 429 (1997).

135. Kull offers a powerful rationale for both outcomes that resolves the paradox: In both cases the court left everything as it was at the time the parties discovered their mutual mistake. All transfers up to that point were valid, but all future obligations disappeared. *See* Kull, *supra* note 6, at 5-6. I analyze his wider and more controversial thesis *supra* notes 104-108.

136. Kull, *supra* note 6, at 41.

Sherwood. In these "contract" windfalls, two parties know of the windfall, and it would be extremely expensive for the government to monitor for such events.[137] If the parties know that the government will tax away their unexpected gain, in whole or in part, they have an incentive to strike a deal themselves and divide up the surplus. The parties are in a bilateral monopoly, however, and negotiations are likely to be protracted.[138] Thus, all the government accomplishes by trying to tax private windfalls is to force the parties into an expensive bargaining game. Efficiency demands, to the contrary, that legal rules help parties avoid such socially wasteful transaction costs. Private windfalls thus are not efficient targets for capture.

Similarly, it is generally infeasible to capture finds: Taxing them away will lead most finders simply to hide their good fortune or leave items lying on the ground.[139] This, of course, frustrates the primary purpose of finders law: promoting the return of goods to their true owners. In some sense, then, we permit finders to retain their spoils when the true owner cannot be determined as a reward for attempting to return them.

Capture is efficient for those rare private windfalls that are both (1) like manna from heaven and do not come at the expense of anyone else, such as the golden meteor discussed in the Introduction; and (2) detectable at low cost. Under existing law, however, taxing away 100% of golden meteors and similar windfalls amounts to a taking without just compensation.[140] Either the courts must reinterpret the word "property" in the Takings Clause, or the people must amend it, for society to capture those rare

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137. Pure private windfall cases like *Wood* and *Sherwood* surface rarely, undoubtedly because it is only in exceptional cases that the party selling an item with surprise value ever hears the good news. The purchaser—recipient of the pleasant surprise—has no incentive to publicize the parties' mutual mistake and risk a lawsuit. Every once in a while, however, a particularly noteworthy contractual windfall becomes public knowledge. *See, e.g., A 50¢ Frame That Just Might Hold a Treasure*, N.Y. TIMES, June 4, 1995, at A29 (reporting how the purchaser of a frame at a flea market found that it contained a draft of Henry Wadsworth Longfellow's poem *The Village Blacksmith*, appraised at approximately $7000).

138. *See* POSNER, *supra* note 39, at 68-69.

139. It is important to distinguish serendipitous finds from discoveries made by the application of toil, skill, and enterprise. This is productive activity bearing only the most facile resemblance to windfalls, and there is no good reason to subject income from such activities to extraordinary taxation in the first place. *See supra* note 39.

While subject to no special tax, finds do count as ordinary income for federal income tax purposes. *See* Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969), *aff'd*, 428 F.2d 812 (6th Cir. 1970) (per curiam) (holding that $4467 in cash found in a used piano purchased by taxpayers for $15 was taxable as ordinary income under the broad language of section 61 of the Internal Revenue Code). Like any tax, this creates some incentive to hide the find and to engage in less finding in the first place, and thus is at odds with the purposes of finders law.

A contrary holding, that finds are not taxable income, would create powerful incentives for taxpayers to recharacterize earned income as "lucky finds" (for example, real estate brokers could claim that they earned commissions serendipitously).

140. This assertion rests on the seemingly universal belief that the law, including the Constitution, protects property obtained via windfalls just as much as it protects property earned by effort or enterprise. *See supra* notes 4-7 and accompanying text.

private windfalls that come at the expense of no one else and are easy for the state to detect.

The second reason society may not be indifferent between two claimants to a private windfall is that transactions costs may make it efficient to award the property to one side. As discussed in Section III.B above, the state can save parties the cost of bargaining by setting a default rule that most parties would select if they contemplated and addressed a contractual windfall. As a first cut, sharing private windfalls seems the efficient outcome. On the assumption that both parties are risk-averse, they will prefer half-size windfalls with twice the probability to full-size windfalls half as often. Put another way, if the parties went to the time and expense to insert a contractual term to cover pleasant surprises, they would likely call for splitting such windfalls. This formalizes Fried's case for a default sharing rule in contract law: "Sharing applies where there are no rights to respect. It is the principle that would apply if a group of us were to land together on some new planet. It is peculiarly appropriate to filling the gaps in agreements, to picking up after contractual accidents."[141]

When valuation is difficult (costly), however, splitting the windfall may not be feasible. Consider a slightly tweaked version of the facts in *Brown v. Voss*.[142] The plaintiff purchased adjacent landlocked lots *B* and *C* from the defendant, owner of lot *A*. The plaintiff planned to build on lot *B* and leave *C* in its natural state, and so the defendant granted her an easement across lot *A* for the benefit of lot *B* only. Then, to everyone's surprise, a local river changed course and now runs much closer to all three properties. Because of the lay of the land, the plaintiff can build a home commanding a river view (and thus of significantly higher value) only if the house straddles lots *B* and *C*.

Efficiency demands that the house be built in its highest-value location, yet the plaintiff's easement benefits only lot *B* and hence a house standing on both lots formally violates—"overburdens"—the easement. The court in *Brown* admitted that a house straddling *B* and *C* technically overburdened the easement, but it upheld the trial court's decision in the plaintiff homeowner's favor as a valid exercise of discretion since the defendant had not suffered the "substantial" harm generally necessary to support an injunction.[143] Had the parties anticipated this contingency in their contract,

141. CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 71 (1981) (footnote omitted). Fried makes the case for sharing losses as well as gains. There may often be a stronger case, however, that in the case of losses one party or the other is the best risk bearer and should therefore absorb the entire loss.

142. 715 P.2d 514 (Wash. 1986).

143. *See id.* at 518.

they might have adopted a sharing rule, but since valuation is so difficult that option might have appeared unattractive ex ante.[144]

When valuation is difficult, permitting the plaintiff to reap the entire windfall may be sensible under an analog of the Coase Theorem.[145] The right to use the easement to benefit lot *C* has higher value in the plaintiff's hands than in the defendant's. Instead of leaving the parties in a bilateral monopoly or engaging in expensive valuation, it is efficient to award the property right to the party valuing it more. This choice obviates the need for socially wasteful negotiation or valuation. This approach is similar to statutes giving owners of landlocked parcels rights of private condemnation: They can obtain easements at market value regardless of any higher value they attach to the right of way.[146]

When there are three or more parties involved, courts and legislatures have another option to achieve efficient ends: assigning property rights to encourage competition (and thus efficient cost-pricing). Litigation over utility easements, for example, often involves multiple holders of vaguely specified rights.[147] The electricity company may have an easement over each lot in a subdivision and, in turn, may have granted the telephone company the right to use these easements for, say, "lines transmitting voice and data." The cable television company then talks to both about buying easements for its lines. The electricity company claims the right to control use by virtue of its original easement; the phone company argues that cable TV signals are "data" and hence it has the exclusive rights to permit (and charge for) cable wire easements. The landowner may claim she granted the utility the right only to run power lines and that she alone had the right to permit use by the phone and cable companies.

Instead of assigning absolute property rights to the utility, the phone company, or the landowners, a court or legislature could deem existing property rights ambiguous and declare that all three have the right to sell an

144. The court could infer that the parties would have agreed to hire an impartial land appraiser to estimate the incremental value of a house straddling the two lots, but such an appraisal itself may be expensive.

145. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

146. Contrary to appearances, private condemnation is not a form of sharing. The condemner pays a fixed value—the cost of her imposition—that is unrelated to the size of any windfall. Similarly, the law of salvage limits awards to the reasonable cost of the rescue, which is supposedly independent of the value of the cargo saved. *See* 3A BENEDICT ON ADMIRALTY, *supra* note 85, §§ 1-4.

In *Brown*, the likely cost of the additional easement would be zero, since the path already existed and the plaintiff's technical overburdening was in reality no additional burden at all. *See Brown*, 715 P.2d at 518.

147. *See, e.g.*, C/R TV, Inc. v. Shannondale, Inc., 27 F.3d 104 (4th Cir. 1994); Centel Cable Television v. Cook, 567 N.E.2d 1010 (Ohio 1991). *See generally* JON W. BRUCE & JAMES W. ELY, JR., THE LAW OF EASEMENTS AND LICENSES IN LAND ¶ 12.07 (1995 & Supp. 1998) (collecting cases).

easement to the cable company. This eliminates a bilateral monopoly problem and insures that the new user can buy at a competitive price.[148]

IV. PUBLIC WINDFALLS

So far this Article has in the main presented only negative results. Part II showed that due to the reporting problem—those experiencing good luck will hide gains—there will be no private market for the "reverse insurance" that risk-averse people likely desire. Part III first documented misuse of the term "windfall." It then described reasons for avoiding contract constructions that create windfalls and reasons that many windfalls cannot be returned to their true owners. Finally, Part III demonstrated that even in the remaining cases of private windfalls, capture is infeasible.

At a more general level, it is not surprising that common-law litigation turns out to be a weak mechanism for the efficient taxation and redistribution of windfalls. Commentators demonstrated that courts possess quite limited mechanisms for implementing widespread redistribution[149] and, more generally, labor at serious disadvantages compared to tax-based regimes.[150] The previous Parts provided additional insight into the common law's weakness as a means of redistributing windfalls. Reverse insurance, like ordinary insurance, requires the combination (pooling) of a large group of people. For ordinary insurance, the many make small contributions to cover the losses of the few; for reverse insurance, the few share their windfalls with the many. Private markets for ordinary insurance achieve pooling via large insurance companies that combine thousands or even millions of insurance buyers into a common pool. Common-law litigation has no such hub and thus cannot construct a very effective pool of windfall recipients.

Thus, those who question the wisdom of spreading risks via the legal system set up a straw man when they demonstrate that the common law of property, contracts, and torts is wholly inadequate to the task. Epstein, one such critic, implicitly admits as much. After persuasively illustrating the common law's shortcomings as a mechanism for risk-spreading, he moves on to the more plausible mechanisms examined in this Part. "[P]rocedural complications [with common law risk-spreading] thus drive us to a very different, administrative solution, in which state officials have the power to

148. This assumes that the new use has no negative effect on existing uses.

149. *See* POSNER, *supra* note 39, at 570. Recall the difficulty courts have in cases involving only three parties: Two parties fight over proceeds that properly belong to a third. *See supra* Section III.C.

150. *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994).

tax the public at large in order to dispense needed payments to persons who have suffered the requisite level of misfortune."[151]

Epstein is extremely pessimistic about the efficacy of any such "administrative solution" rooted in "the power to tax." His doubt stems in part from his failure to treat bad luck and good luck as analytically distinct. Since there is no market failure for ordinary insurance (against bad luck), he seems to imply that the nonexistence of a market for reverse insurance merely reflects consumers' preferences. For good luck, however, we have seen that the market fails. Windfalls must be pooled, if at all, by the government.

While the reporting problem and the cost of monitoring make capturing private windfalls economically undesirable, neither stands in the way of capturing public windfalls: Events affecting a broad swath of the population are not secrets and the cost of monitoring for them is effectively zero. This Part provides grounds for a moderately sanguine view of advanced societies' opportunities to share public windfalls. It provides a series of historical examples, from early American land law to insider trading, showing that legislatures and executives have long used a variety of mechanisms to assure that windfalls are shared among the citizenry. On rare occasions, such sharing can be tailored closely to redistribute from winners to losers, as illustrated in Section IV.A. The remainder of Part IV studies cases of less finely tuned capture of windfalls. Section IV.B deals with cases where the government extracts windfalls directly from their lucky recipients and spreads the benefit over the populace. Section IV.C examines structurally different but distributionally similar cases, where the government makes sure it pays no more than cost when it needs something from citizens, be it their property or their services as private attorneys general. In all three contexts, developed bureaucracies and relatively efficient information gathering and processing have greatly expanded modern nations' ability to capture windfalls.

A. *Tightly Coupled Windfall Capture*

When independent participants involved in some enterprise know that "dumb luck" will have a significant effect on who flourishes and who fails, there is a strong incentive to strike some sort of risk-pooling agreement ex ante. Risk-averse actors prefer predictable, middling income to chances for reaping windfalls purchased with the risk of starvation. Those constructing such insurance pools, of course, must make sure to preserve incentives for effort and enterprise. This Section examines two historical examples of

151. Epstein, *supra* note 7, at 30. Epstein addresses bad luck, but he treats good and bad luck symmetrically, overlooking the reporting problem.

risk-management devices. Relatively primitive medieval governments were simply incapable of windfall capture, yet their open-field system of agriculture was an impressive tightly coupled insurance scheme. Over the last hundred years, modern governments have experimented with measures to make beneficiaries, instead of the public at large, pay landowners economically harmed by zoning and land use controls. It is a testimonial to the difficulty of such closely tailored windfall capture that these measures have had, at best, mixed success.

The medieval open-field agriculture system was an ingenious institution for pooling risk while maintaining incentives.[152] Productivity of adjacent land varies significantly because of soil quality and localized incidence of weather (for example, hail) and pests (vermin and microbes). One way to minimize the risk of a family starving due to an unusually unlucky growing season would have been communal farming: All families work on all the village's arable land as a group and divide up the harvest per capita. As catastrophic experiments with collective agriculture during this century have demonstrated beyond peradventure,[153] however, communal production creates irresistible incentives to free ride on the work of others.

The open-field system granted each family property rights in randomly distributed strips of land scattered throughout village lands. Thus, if hail destroyed crops in the northern half of the fields, everyone suffered nearly equal losses. Yet each family's remaining harvest, taken from their strips in the unharmed southern fields, would depend directly on their own sweat and toil. Giving each family one large block of land, instead of scattered strips, would preserve incentives to work hard, but it would result in windfalls for some and wipeouts for others. Dividing land holdings into noncontiguous strips was a simple means to spread risks.

A set of modern statutes around the globe have attempted to make those receiving windfalls due to government projects, land use, and regulation pay off those harmed by the same measures.[154] Perhaps the most common

152. The following discussion draws heavily on Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1388-91 (1993), which contains numerous references to historical and economic analyses of medieval open-field agriculture.

153. For a detailed summary of the tragedy resulting from Soviet attempts to collectivize agriculture, see DMITRI VOLKOGONOV, STALIN: TRIUMPH AND TRAGEDY (Harold Shukman ed. & trans., 1991). On China, see JONATHAN D. SPENCE, THE SEARCH FOR MODERN CHINA 583 (1990) (describing the result of collectivization efforts in Mao's "Great Leap Forward" in the late 1950s as "famine on a gigantic scale, a famine that claimed 20 million lives or more between 1959 and 1962"). For a discussion of the more recent failure of communal agriculture in Ethiopia, see DAWIT WOLDE GIORGIS, RED TEARS: WAR, FAMINE AND REVOLUTION IN ETHIOPIA 265-80 (1989). For additional citations documenting the almost universal failure of collectivized agriculture, see Ellickson, *supra* note 152, at 1318 nn.4-7, 1335 nn.73 & 75.

154. For an extensive review of these laws and related policy discussions, see WINDFALLS FOR WIPEOUTS: LAND VALUE CAPTURE AND COMPENSATION (Donald G. Hagman & Dean J. Misczynski eds., 1978). The editors use a subject-specific definition: "A windfall,. broadly

example is rezoning. When a locality rezones a lot from, say, multifamily dwellings to open space, the market value of the lot falls precipitously—a wipeout.[155] Adjacent owners, conversely, receive a windfall in the form of a quiet park or forest next door instead of noisy neighbors. The owner of the rezoned lot, of course, likely has a takings claim and can sue the state for just compensation. Many governments have searched for ways to reduce or eliminate government payment by raising compensation for harmed landowners from the benefited neighbors, instead of making all citizens pay via the public fisc.[156]

All measures taxing benefited landowners to fund those harmed by governmental action share some of the flavor of the venerable mechanism of special assessments,[157] where, for example, those serviced by a new road or sewer line pay a one-time tax (that is, a special assessment) to cover the cost of the project. Matters become more complex, however, when government action harms as well as helps landowners. One early attempt to circumvent takings challenges to zoning, pretty much explained by the accurate if loquacious title "Zoning by Special Assessment Financed Eminent Domain" (ZSAFED), called for special assessments against those benefited to fund payments to those harmed. ZSAFEDs date back over a hundred years; despite surviving constitutional challenges, they fell into disfavor due to administrative expenses, especially in connection with the difficulty of quantifying the size of the gains and losses to all affected parcels.[158]

More recent attempts to capture windfalls arising from governmental action, called Special Capital and Real Estate Windfall Taxes (SCREWTs), in effect give up the effort to tax property-value increases precisely due to

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conceived, is an increase in property value caused by public action; a wipeout is an analogous decrease." Donald G. Hagman & Dean J. Misczynski, *Introduction* to WINDFALLS FOR WIPEOUTS, *supra*, at 1, 1.

155. *See, e.g.*, Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1007 (1992).

156. *See* Donald G. Hagman & Dean J. Misczynski, *Executive Summary*, *in* WINDFALLS FOR WIPEOUTS, *supra* note 154, at xxix, xl-xli.

157. Special assessments date back to at least 1287, when an ordinance required residents of Sussex, England, to pay for shoring up a sea wall. The statute based assessments on the size of a landowner's acreage that benefited from the sea wall. *See* EDWIN CANNAN, THE HISTORY OF LOCAL RATES IN ENGLAND 11 (1912). By the 1890s, special assessments were common practice in the United States. *See* TAX FOUND., SPECIAL ASSESSMENTS AND SERVICE CHARGES IN MUNICIPAL FINANCE 8 (1970).

158. Apparently, homeowners on Gladstone Boulevard in Kansas City, Missouri, were the first to prod a locality to adopt a ZSAFED in order to preserve the residential character of their neighborhood. Thirty years later the statute survived a constitutional challenge. *See In re* Kansas City Ordinance No. 39946, 252 S.W. 404 (Mo. 1923) (upholding the constitutionality of a ZSAFED against, inter alia, a challenge that the benefit for homeowners in one neighborhood was not a public use for which the state could invoke its takings power). For additional history and analysis of ZSAFEDs in both the United States and abroad, see Douglas G. Hagman, *Betterment for Worsement: The English 1909 Act and Its Progeny*, *in* WINDFALLS FOR WIPEOUTS, *supra* note 154, at 491; and Donald G. Hagman, *Zoning by Special Assessment Financed Eminent Zone (ZSAFED)*, *in* WINDFALLS FOR WIPEOUTS, *supra* note 154, at 517.

governmental action; instead, they tax the increase in property values between purchase and sale, much like a capital gains tax. A number of local jurisdictions in the United States, Canada, Australia, and New Zealand employ taxes of this type. Though simpler than ZSAFEDs, SCREWTs are still relatively complex; their usefulness for capturing windfalls at reasonable costs is unclear, and thus so is their future.[159]

The windfall capture mechanisms examined in the remainder of Part IV inure to the benefit of the entire taxpaying public, either through greater tax revenue (Section IV.B) or lower governmental expenditures (Section IV.C). These two categories differ significantly in structure but not in substance. Section IV.B examines the simpler case, in which someone receives a windfall and the government captures it via taxation. Section IV.C considers situations in which a citizen holds some property (or property-like) right that surprisingly becomes of enhanced value to the public. While the government could pay a high price and then turn around and assess a windfall tax, it is administratively cheaper to establish rules allowing the government to obtain the good at a lower price that does not impound any windfall "premium." While the means differ, the end is the same in both cases: spread the value of a windfall over all or most of the citizenry. In some cases, spreading the windfall over the entire population is desirable: for example, when selling government lands (in theory owned by the citizenry per capita) that may have valuable minerals. In other cases, there is a narrower group to whom society would like to channel the windfall (e.g., oil consumers in the case of the Windfall Profit Tax on Oil after the OPEC embargo), but such precision is administratively too costly.

B. *State Extraction of Windfalls*

1. *American Soil and Its Riches*

At its independence, the United States took title to millions of uninhabited and unexplored acres.[160] For over 100 years, perhaps the single most important function of the federal government was selling off these vast holdings. While many characteristics contributing to the value of a given section were widely known (for example, proximity to lakes, rivers, roads, or towns; climate; danger from Native Americans), other important

159. *See* Madelyn Glickfield & Donald G. Hagman, *Special Capital and Real Estate Windfalls Taxes (SCREWTs), in* WINDFALLS FOR WIPEOUTS, *supra* note 154, at 437 & back leaf tbl.20-1.

160. The individual states originally held title to Western lands, but, after considerable haggling, each ceded its holdings to the federal government. *See* MERRILL JENSEN, THE ARTICLES OF CONFEDERATION: AN INTERPRETATION OF THE SOCIAL-CONSTITUTIONAL HISTORY OF THE AMERICAN REVOLUTION 1774-1781, at 225-38 (1940).

attributes remained the secrets of a few men or the secrets of nature. Surveyors, often the first and only Europeans to scout land before sale, had unmatched knowledge about soil quality, for instance. At times, they acquired much more valuable information, such as the location of a saltlick[161] or a mine. Everyone knew, however, that many mines (for coal, lead, and precious metals) undoubtedly lay hidden on plain-looking acreage.

In 1781, even before the United States had won its independence, Pelatiah Webster voiced concern that valuable acres would fall into private hands without payment of fair consideration. He proposed that

> all saltlicks, and mines . . . and all [valuable minerals] . . . 'in which the country greatly abounds,' may be reserved and sequestered for public use: a great revenue may grow out of them: and it seems unreasonable that those vast sources of wealth should be engrossed and monopolized by any individuals. . . . [T]he vast profits issuing from them should flow into the public treasury, and thereby inure to the advantage of the whole community.[162]

There are two potential worries here, and Webster may have contemplated both. First, the United States as the selling principal needed to guard against unfaithful agents colluding with buyers. A surveyor who knew the location of a lead mine, for instance, could sell the information, bid on the land himself, or enter into a secret partnership with other buyers.[163] George Washington seemed concerned about such disloyalty when he asked an associate about a potential safeguard:

> Would there be any impropriety do you think sir, in reserving for special sale, all Mines, minerals and Salt springs in the general Grants of Land belonging to the United States. The Public, instead of the few knowing ones, might in this case derive the benefits which would result from the sale of them, without infringing any rule of justice that occurs to me, or their own laws . . . .[164]

Webster also seemed worried about windfalls: the existence of, for example, a gold mine unknown to either the United States as seller or to

161. Streams of water with high salt content, saltlicks were a valuable resource for farmers raising animals.

162. PELATIAH WEBSTER, POLITICAL ESSAYS ON THE NATURE AND OPERATION OF MONEY, PUBLIC FINANCES, AND OTHER SUBJECTS 497-98 (Philadelphia, Joseph Crukshank 1791).

163. Such breaches of faith by local officials were common. *See* PAUL W. GATES, HISTORY OF PUBLIC LAND LAW DEVELOPMENT 705 (1968); MALCOLM J. ROHRBOUGH, THE LAND OFFICE BUSINESS: THE SETTLEMENT AND ADMINISTRATION OF AMERICAN PUBLIC LANDS, 1789-1837, at 32-34, 197-99 (1968).

164. Letter from George Washington to Richard Henry Lee (Dec. 14, 1784), *in* 28 THE WRITINGS OF GEORGE WASHINGTON 9, 11 (John C. Fitzpatrick ed., 1938).

buyers. The parties could have dealt with such contingencies by increasing the price paid for land to reflect the likelihood of finding unexpected wealth, but this would have been quite difficult. Estimating the odds of a mine on government land, and its value, would involve great uncertainty. Moreover, this approach seems unattractive to buyers interested in farming. Assuming, as usual, that they are risk-averse, farmers buying farmland would find even fairly priced "tickets" to play in a "mining lottery" unattractive. The government thus would expect to find higher bidders elsewhere, and one might expect to see it separate mineral rights from other land rights.

In the first statutes governing land sales, the national government pursued precisely such an approach. In 1785, the Continental Congress reserved for the government "one-third part of all gold, silver, lead and copper mines, to be sold, or otherwise disposed of as Congress shall hereafter direct."[165] Congress did not invent this measure. Under the common law of England, the Crown owned all gold and silver, and royal land grants in the colonies continued this tradition in one form or another.[166] When locating minerals was largely serendipitous, as opposed to the result of the significant investments utilized in modern times, letting mineral wealth essentially fall into the lap of the purchaser of well-situated farm acreage did amount to a windfall.

The King, and later the United States, may have ceded a portion of mine output to landowners in order to induce them to search for valuable minerals and to reduce the incentive to keep such finds secret. The young nation, however, simply lacked the resources to monitor effectively the acts of thousands of landowners on the frontier and thus never could enforce the rights it tried to reserve. Disloyal agents bought up the tracts themselves rather than disclose the location of mines to the government. Squatters mined parcels until ejected by bona fide purchasers. After a series of attempts to enforce the nation's rights over mineral wealth on lands, Congress by 1846 largely gave up on its efforts to reserve a portion of mineral windfalls for the nation.[167]

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165. 10 JOURNALS OF THE CONTINENTAL CONGRESS 378 (May 20, 1785).

166. *See* SIR EDWARD COKE, THE SECOND PART OF THE INSTITUTES OF THE LAWS OF ENGLAND *577-78 (David S. Berkowitz & Samuel E. Thorne eds., Garland Publ'g 1979) (1642) (explaining the King's claim based on the necessity of precious metals for coinage). Early grants in Massachusetts colonies reserved to the Crown one-fifth of all gold and silver discovered. *See* James Warren Springer, *American Indians and the Law of Real Property in Colonial New England*, 30 AM. J. LEGAL HIST. 25, 32 (1986) (citing 1 RECORDS OF THE GOVERNOR AND COMPANY OF THE MASSACHUSETTS BAY IN NEW ENGLAND 4, 9 (Nathaniel B. Shurtleff ed., Boston, William White 1853-1854)). Other grants hewed to English tradition and reserved all gold and silver for the King. *See* ALBERT TANGEMAN VOLWILER, GEORGE CROGHAN AND THE WESTWARD MOVEMENT 1741-82, at 251 (1926) (discussing a 1769 grant in New York State to George Croghan).

167. *See* GATES, *supra* note 163, at 700-07.

2. *Taxing Away Windfalls*

The government had extremely limited means to capture windfalls during the nation's first century. The rapid growth of the modern bureaucratic state in the late 1800s and early 1900s, however, changed the administrative landscape. Perhaps no mechanism played a greater role in this growth, and the concomitant ability to capture windfalls, than the establishment of a federal income tax.[168] With statutes, regulations, personnel, and all the other implements of a modern revenue-collection system in place, the United States by 1917 had the ability to tax perceived windfalls directly.

The Subsections that follow first contrast the two major extraordinary profits taxes imposed by the federal government since it has had the ability to impose such levies: the excess profits taxes imposed during the two world wars and the windfall profits tax imposed on oil producers in the wake of OPEC's successful price hikes in the 1970s. The subsequent Subsections then argue that progressive taxation, and the doctrine of escheat, are forms of windfall capture.

a. *Excess and Windfall Profits Taxation*

i. *Excess Profits Taxes During the World Wars*

Nobel Prize-winning economist John Hicks outlined two very different ways for a nation to levy taxes on exceptional wartime profits:

> A *war profits* tax is a tax on windfall profits; since there is very little reason in equity for claiming that anyone has the right to such profits in war-time, the special taxation of these profits can give little justifiable cause for complaint. But as soon as any element of the *high profits* principle is included, the tax becomes . . . a general profits tax . . . .[169]

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168. The Sixteenth Amendment to the Constitution, ratified in 1913, established the validity of a federal tax on income. *See* U.S. CONST. amend. XVI. Soon thereafter, a leading account discussing the nation's ability to raise money for the war effort noted that "[w]e appreciate more than ever before the great advantage of having developed the administrative machinery of the income tax." T.S. Adams, *Federal Taxes upon Income and Excess Profits*, 8 AM. ECON. REV. 18, 40 (Supp. 1918) (quoting the comments of Arthur N. Young); *see also* ROBERT M. LA FOLLETTE, WAR PROFITS TAX: IS IT DISLOYAL TO ADVOCATE THE TAXATION OF WAR PROFITS AND SURPLUS INCOMES? 3-32 (1917) (containing speeches before the Senate on Sept. 1, 1917 and Sept. 10, 1917).

169. JOHN R. HICKS ET AL., THE TAXATION OF WAR WEALTH 42 (1942) (emphases added).

Hicks uses the term "war profits" to describe a carefully targeted windfall profits tax (WPT), in contrast with a general tax on "high" profits whether or not they arise due to wartime spending—an excess profits tax (EPT).

Both Britain and the United States assessed EPTs, not WPTs, during the world wars. These choices may have some historical roots,[170] but they appear to have been largely a product of expediency. As argued in this Subsection, it is very difficult to construct a WPT narrowly targeting only war profits. Unfortunately, EPTs are not good substitutes for WPTs. The EPTs implemented during the world wars warped incentives and thus created inefficiencies.

Though largely forgotten, EPTs funded a large portion of the United States' expenditures during both world wars.[171] The tax was part and parcel of the decision, often implicit, to leave most of the wartime economy in private hands, on the belief that, during war as during peace, the market would produce goods more efficiently than the state: "The case for some utilization of economic incentive in war-time is . . . based upon the practical impossibility of bringing the whole of a nation's economic activities under control—or at least under effective control."[172]

Enterprises and their owners possessing goods and services in high demand inevitably accrue war wealth.[173] Cases of spectacular profits became public knowledge and caused outrage from the beginning of World War I. One of the first and most infamous cases in Britain was a 400% increase in the profits of Spillers & Bakers, a grain-trading firm, between 1913 and 1914. The firm apparently locked in low prewar prices for large amounts of imported flour and sold at war-inflated prices.[174] The American experience was similar though more extreme. Doubling of profits was

170. During the Civil War, the Confederate State of Georgia enacted a business profits tax, with an exemption based on capital, that was similar in many ways to the world war EPTs. *See* KOSSUTH KENT KENNAN, INCOME TAXATION: METHODS AND RESULTS IN VARIOUS COUNTRIES 212-14 (1910). Michigan classified railroads according to net earnings per mile and assessed an EPT-like tax with rates depending on this measure. *See* HENRY CARTER ADAMS, THE SCIENCE OF FINANCE 466 (New York, Holt & Co. 1898).

171. During World War I, "[f]inancially, the excess profits tax was a huge success. It formed the backbone of our war tax system . . . ." KENNETH JAMES CURRAN, EXCESS PROFITS TAXATION 189 (1943). By the end of the war, it accounted for 59% of the American government's revenue. *See id.* at 136-37 & tbl.3. At its peak, the British EPT raised about 36% of the government's revenue. *See* JOSIAH STAMP, TAXATION DURING THE WAR 249 app.IV (1932). During World War II, the EPT at its peak raised about 23% of federal government revenue. *See* U.S. TREASURY DEP'T, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES 562-63 (1945) (noting that the EPT raised $5 billion out of a total revenue of $22 billion in the fiscal year ending on June 30, 1944).

172. HICKS ET AL., *supra* note 169, at 4.

173. "The only effective way of preventing war wealth from arising is to rely upon the compulsory method of mobilization rather than the voluntary method . . . ." *Id.* at 2.

174. *See* STAMP, *supra* note 171, at 39-40; *see also id.* at 42 (stating that profits of the King's Norton Metal Company rose 350% from 1913 to 1914).

common, while a few firms experienced increases of a factor of ten or even close to fifty.[175]

Sweden and Denmark imposed the first special profits tax during World War I, in reaction to the spectacular profits of traders and shippers who, due to the allied blockade of the North Sea, possessed the sole remaining trade routes into Germany, through the Baltic Sea.[176] Once enacted, the EPT, "[l]ike the Spanish influenza... speedily infected all the belligerent countries on both sides . . . ."[177] Britain and the United States first enacted narrowly focused taxes on munitions makers, but they soon passed laws assessing an EPT on all corporations.[178]

Many leaders and economists believed that the EPT should survive the war as an important source of public revenue.[179] Opponents of the EPT, however, succeeded in repealing the tax after the war's end and prevented reenactment until World War II.[180] History repeated itself in the early years of World War II, however, as both the United States and Britain first enacted special taxes on munitions makers[181] and followed with economy-wide EPTs.[182] Most recently, the United States relied on an EPT during the Korean War.[183]

Ordinary profit (that is, business income) taxes apply to all net income. An EPT applies only to "excess" profits, but there is no obvious way to define excess profits. While statutes varied significantly in detail, all defined excess profits in one of two basic ways. Some provisions defined

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175. The profits of the American Agricultural Chemical Company and Standard Oil of New York doubled between 1913 and 1916. Du Pont's profits increased 14-fold over the same period, while the American Zinc, Lead, and Smelting Company saw profits rise by a factor of 45. *See* LA FOLLETTE, *supra* note 168, at 27.

176. *See* PAOLO E. COLETTA, SEA POWER IN THE ATLANTIC AND MEDITERRANEAN IN WORLD WAR I, at 25-28, 29 map (1989).

177. Carl C. Plehn, *War Profits and Excess Profits Taxes*, 10 AM. ECON. REV. 283, 285 (1920)

178. *See* CURRAN, *supra* note 171, at 8. The United States passed the Vinson-Trammel excess profits tax on munitions manufacturers as Title III of the Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756, 780-82 (1916). In the ensuing years of World War I, Congress passed a succession of more broadly based and more complex EPTs. *See* Revenue Act of 1917, Pub. L. No. 64-377, tit. II, 39 Stat. 1000, 1000-02; War Expense Act, Pub. L. No. 65-50, tit. II, 40 Stat. 300, 302-08 (1917); Revenue Act of 1918, Pub. L. No. 65-254, tit. II, 40 Stat. 1057, 1088-96 (1919).

179. In 1919, President Wilson advocated a permanent EPT as a way to "reach undue profits without discouraging the enterprise and activity of our business men." 58 CONG. REC. 41-42 (1919).

180. President Roosevelt's New Deal included a very modest EPT in the National Industrial Recovery Act, Pub. L. No. 73-67, §§ 216-17, 48 Stat. 195, 208-09 (1933). This measure, however, was designed not to raise revenue, but rather to encourage businesses to assess fairly their capital stock for a complementary tax on capital stock. *See id.* § 215, at 207-08.

181. The (second) Vinson-Trammel Act taxed naval contractors 100% of profits in excess of the contract price. *See* Act of March 27, 1934, Pub. L. No. 73-135, § 3(b), 48 Stat. 503, 505.

182. The United States enacted an EPT during initial mobilization, before it had entered the war. *See* Second Revenue Act of 1940, Pub. L. No. 76-801, tit. II, 54 Stat. 974, 975-98.

183. *See* JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 137-44 (1985).

any return on capital over a fixed percent as excess profits.[184] This is clearly an economy-wide EPT that makes no attempt to target war windfalls. Other provisions defined excess profits as net income in excess of prewar levels.[185] Most American and British EPTs gave firms the choice of using either method to determine the EPT they owed.[186]

In the view of some politicians, identifying extraordinary war profits was easy, and taxing them had no adverse impact on effort or enterprise. "[P]recisely because the war profits which it is proposed to reach by taxation... are abnormal profits, arising from abnormal causes, substantially all of them might be taken by the Government in taxation without disturbing normal business conditions, providing only that all kinds of business producing war profits are treated the same."[187] A prominent economist went even further, justifying an EPT even during peacetime. "[The EPT] represents, as it were, the share of the state in the 'supernormal' success of every business enterprise. It measures roughly the value of the facilities, opportunities, and environment provided by the community.... [T]he state and community stand as silent partners in every business enterprise."[188]

Most experts at the time, however, realized that defining a normal level of profit for one firm, let alone for an entire economy, was difficult if not impossible.[189] One serious problem was accounting for the varying riskiness of enterprises. A foundational principle of modern finance theory, undoubtedly known intuitively since the dawn of capitalism, is that those

184. America's first World War I EPT, Title II of the Revenue Act of 1917, Pub. L. No. 64-377, 39 Stat. 1000, 1000-02 (1917), taxed profits above eight percent of invested capital, plus $5000, at an eight-percent rate.

185. Title II of the War Revenue Act, Pub. L. No. 65-50, 40 Stat. 300, 302-08 (1917), added an alternative definition of excess profits: those exceeding average profits in the three years preceding the war.

186. By the end of World War I, both Britain and the United States offered taxpaying firms such a choice. *See* session laws cited *supra* note 178; Plehn, *supra* note 177, at 287. Both nations offered the same choice throughout World War II. Congress enacted the first World War II EPT in 1940. *See* Second Revenue Act of 1940, Pub. L. No. 76-801, tit. II, 54 Stat. 974, 975-98 (1940). Both definitions survived equal protection challenges despite disparate impacts resulting from prewar profit fluctuations, varying definitions of invested capital across industries, and other sources of seeming unfairness in application. *See* LaBelle Iron Works v. United States, 256 U.S. 377 (1921).

187. LA FOLLETTE, *supra* note 168, at 16-17. For similar optimism about separating war profit windfalls from fairly earned profits, see 54 CONG. REC. 2319 (statement of Rep. Dickinson) (1917) ("[T]hose who reap large war profits in times of distress should help to bear the burdens of Government, increased by reason of the very conditions that add to the wealth of those who flourish and fatten on the misfortunes of the country.").

188. Adams, *supra* note 168, at 19-20 (1918). Commentators continue to define windfall profits as equivalent to excess profits. *See* HAROLD S. SLOAN & ARNOLD J. ZURCHER, DICTIONARY OF ECONOMICS 467 (5th ed. 1970) (defining a windfall profit as "[a] profit in excess of that which can be considered normal").

189. *See* STAMP, *supra* note 171, at 41 (arguing that "the difficulty in determining what were war profits [is] fundamental"); Plehn, *supra* note 177, at 285 ("[T]he line of demarcation between 'war profits' and other unusual profits proved exceedingly hard to draw.").

taking greater risks demand greater rewards.[190] Economists realized that defining excess profits as returns above a given percentage for all businesses was inappropriate. "The burden must not apply with full rigor to profits won at great hazard. Some crocks of cream appear to be richer than they are."[191] One early advocate of the EPT admitted that failure to account for varying risk was a fundamental flaw.

> Everyone recognizes that the same rate of return which would be fair to banks would be unfair to the men who make a business of prospecting or 'wild-catting' for minerals and oil....
>
> ....
>
> ... The percentage deduction should vary with the risk....
>
> ... The excess profits tax has grievously sinned in overtaxing profits derived from the more hazardous and difficult industrial undertakings.[192]

This shortcoming led some to advocate the use of past profits to define a baseline for excess wartime profits.[193] But using history to define "normal" profits involves a host of difficulties as well. Many businesses became especially risky during wartime and hence deserved higher profits.[194] Since profits vary significantly from year to year, using a historical base for the EPTs made taxes vary arbitrarily from firm to firm.[195]

Perhaps the greatest difficulty was making exceptions for firms designed to serve wartime needs. British policymakers realized that they had to make an exception for businesses that "had been carried on continuously for a great many years in peace time, not with the expectation or the hope, but on the possibility that one day in war time they might recoup themselves for their loss."[196] This amounts to an implicit admission that it was a mistake to assess EPTs against munitions manufacturers—always the first target.[197] For businesses whose planning even in part reflected the possibility of war, high wartime profits are no windfall. Nations leaving the means of production in private hands want some firms to maintain capacity for wartime needs—and must be willing to reward such firms when the nation needs their output.

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190. *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 129-212 (4th ed. 1991) (explaining in detail the theory and evidence showing that returns are positively correlated with risk).

191. Robert Murray Haig, *British Experience with Excess Profits Taxation*, 10 AM. ECON. REV. 1, 12 (1920).

192. Thomas S. Adams, *Should the Excess Profits Tax Be Repealed?*, 35 Q.J. ECON. 363, 380, 390, 392 (1921).

193. *See, e.g.*, OTTO H. KAHN, SOME COMMENTS ON WAR TAXATION 24 (1917).

194. *See* STAMP, *supra* note 171, at 182.

195. *See* Adams, *supra* note 192, at 388-89.

196. STAMP, *supra* note 171, at 48-49.

197. *See supra* text accompanying note 178.

So far I have examined only the tax base of the wartime EPTs. The marginal rate applied to the various bases varied considerably, rising as high as ninety percent.[198] Commentators derided the waste that inevitably resulted from such high rates.[199] The perverse economic incentives were simple. "When the government took [eighty-six percent] of an excess profit . . . the tendency was to buy any article selling for £100 which had a value to the taxpayer of £14 or more."[200] The tactics employed were diverse and clever: charging low prices to earn customer goodwill, making "[r]enovations and repairs . . . on a lavish scale," advertising with previously unseen intensity, hiring family members for nonexistent jobs, and paying inordinate salaries.[201] A prominent financier noted, long before the development of the Laffer Curve, that high tax rates can lead to such severe avoidance that a shrinking tax base more than offsets the higher rate and leads to reduced government tax receipts.[202]

Whatever base and rate lawmakers adopted, the bottom-line economic question was the effect of a tax on incentives to work hard and take calculated risks.

> If the offer of higher incomes to certain people does succeed in stimulating war production in those directions where it is most needed, then the nation which secures this stimulus in return for a draft on the future may have made a very good bargain. Higher incomes which do not result in any such stimulus are, however, likely to occur . . . [and] their occurrence is one of the main

198. While under Title II of the Revenue Act of 1942, Pub. L. No. 77-753, 56 Stat. 798, 899-936, the marginal tax rate on excess profits was 90%, a separate provision limited an enterprise's total tax to 80% of net income. The 1934 Vinson-Trammel Act taxed 100% of naval contractor profits. *See supra* note 181. Such a high tax rate "is beyond all question very dangerous indeed," HICKS ET AL., *supra* note 169, at 44, as the nation soon realized. "As the [American] rearmament program progressed, there developed throughout the country a belief that the severe restrictions placed upon profits by the Vinson-Trammel Act were retarding plant expansion and production in the defense industries." CURRAN, *supra* note 171, at 172. Congress repealed the Act when it imposed the general wartime EPT in 1940.

199. *See* Haig, *supra* note 191, at 6 ("There was much evidence that the war tax . . . had led to extravagant and wasteful expenditure . . . ."); *see also* CURRAN, *supra* note 171, at 5 (noting "[t]he tendency of an excess profits tax to lead to wasteful expenditures and lax methods in industry").

200. Haig, *supra* note 191, at 9.

201. *Id.* at 7-9.

202. *See* KAHN, *supra* note 193, at 20. Kahn himself took no credit for this relationship, which economist Arthur Laffer rediscovered to much fanfare in the late 1970s. *See* Arthur B. Laffer, *Statement Prepared for the Joint Economic Committee* (May 20, 1977), *reprinted in* THE ECONOMICS OF THE TAX REVOLT: A READER 75-79 (Arthur B. Laffer & Jan P. Seymour eds., 1979). Kahn regarded the insight as ancient: "It is one of the oldest principles of taxation that an excessive impost destroys its own productivity." *Id.* at 21.

For a comprehensive analysis and historical summary of the idea behind the Laffer Curve, tracing it back at least to ADAM SMITH, THE WEALTH OF NATIONS (1776), see Don Fullerton, *On the Possibility of an Inverse Relationship Between Tax Rates and Government Revenue*, 19 J. PUB. ECON. 3 (1982).

> objections against the use of supply and demand as a means for the mobilization of resources in wartime.[203]

To take concrete examples, munitions experts undoubtedly were awarded extraordinary income during World Wars I and II in order to induce them to work hard and to lure additional bright minds into the field. On the other hand, the owner of an existing oil field might reap pure rents due to intense wartime demand. This Article defines such rents as a windfall. Hicks concurred, noting that such rents comprised "the only part of the war debt... which does correspond to a genuinely reprehensible form of war wealth."[204] While taxes on munitions experts were "dangerous expedients so far as they checked the economic incentive to efficiency," taxes on those reaping economic rents were "useful expedients [insofar as] they succeed[ed] in reducing the cost of obtaining [efficient wartime production], and in distributing the economic burden of war in a more equitable manner."[205]

EPTs taxed marginal profits, the last incremental dollars earned, and hence seriously undermined incentives for effort and enterprise that would increase the amount of war material produced.[206] Even advocates admitted that the tax seemed "calculated to depress industry, to check enterprise at its very inception."[207] Legislators and administrators soon became aware that the EPT undermined the very incentives that justified leaving war production in private hands and added a wide variety of measures to reward new investment.[208] These attempts to mitigate the disincentives inherent in EPTs led to the extraordinary complexity emphasized by virtually every commentator.[209]

203. HICKS ET AL., *supra* note 169, at 23.

204. *Id.* at 23-24.

205. *Id.* at 8. While there was significant worry about the outbreak of war, the actual outbreak of hostilities in the fall of 1914 was still surprising, and thus it is far from clear that the likelihood of war was capitalized into asset prices. *See* MARTIN GILBERT, THE FIRST WORLD WAR: A COMPLETE HISTORY 11, 13 (1994) ("[W]ar seemed unlikely in the spring and summer of 1914.... [T]he fact that almost every European Head of State was related by marriage to every other... created bonds that seemed unbreakable.").

206. *See* HICKS ET AL., *supra* note 169, at 43.

207. Adams, *supra* note 168, at 45 (quoting Edwin R.A. Seligman).

208. *See, e.g.*, Revenue Act of 1941, Pub. L. No. 77-259, § 203, 55 Stat. 687, 702 (containing special tax provisions for new plants useful only during wartime); CURRAN, *supra* note 171, at 181-82 (encouraging increased production by allowing new plant expenditures to count 125% in defining invested capital); Plehn, *supra* note 177, at 287, 292 (describing administrative measures varying tax rates to address differences in risk across enterprises).

209. *See, e.g.*, CURRAN, *supra* note 171, at 178 (stating that the EPT "proved next to impossible for any one other than the tax expert to understand"); Adams, *supra* note 192, at 369 (describing enormous "resentment at [the EPT's] intricacy"). The Secretary of the Treasury himself complained about the complexity of the EPT in an annual report after the war. *See* 1920 DEP'T. OF THE TREASURY ANN. REP. 30. Though similar perceptions are common today, taxpayers in the nascent days of the income tax found it preposterous that officials and experts often disagreed about key aspects of the EPT. *See* Adams, *supra* note 168, at 46.

It is instructive to contrast the imposition of the EPT on industry with the complete absence of any special tax on farmers. Policymakers quite properly noted that "it was illogical to be urging [farmers] in every way to put more land under cultivation and increase the food-supply, and at the same time render them liable to special taxation if they did so."[210] The obvious question, then, is why the same logic did not apply to industry.

It is clear that the wartime EPTs were inimical to incentives for extra effort and enterprise. In theory, however, it is possible to construct a tax that "aims at windfalls, the fruits of chance and luck, monopoly gains, war profits and the like."[211] The key insight is to realize that many (though by no means all) owners of capital and resources existing at the onset of hostilities did indeed reap a windfall when wartime demand surprisingly made their holdings more valuable. These rents were windfalls, "the fruits of chance and luck, monopoly gains," and taxing them is efficient both as a source of revenue and as a means of risk-spreading (again, as long as transaction and administrative costs are not prohibitive). Special wartime taxes should not apply, however, to investments in plants and discoveries of resources made in anticipation of war or made after war begins. Thus, farmers should have been assessed special taxes on acreage planted at the onset of a war, but not on additional acres brought under cultivation. Such a tax structure would not interfere with incentives to produce more; it would merely tax windfall profits to existing levels of enterprise. Separating pre- and postwar investments and discoveries, however, would have been an administrative nightmare.

There may have been important sociological and political reasons for EPT taxation during wartime. "The excess profits tax has been pointed to as an assurance that there would be no profiteering in urging all groups in the economy to cooperate in the prosecution of the war."[212] With an entire generation of men heading off to the front lines, "the public was in no mood to tolerate a situation that promised extravagant profits to industry at a time when selective service was imposing severe sacrifices upon hundreds of thousands."[213] There was a widespread perception that the public simply would not tolerate enormous profits while so many were sacrificing their lives; in Britain, " '[t]he indignation of the country was brought to boiling-point'" by reports of extraordinary profits of firms like Spillers & Bakers.[214] President Roosevelt was so sensitive to this public concern that in

210. STAMP, *supra* note 171, at 71.

211. Adams, *supra* note 192, at 367.

212. MARION HAMILTON GILLIM, THE INCIDENCE OF EXCESS PROFITS TAXATION 55 (1945).

213. CURRAN, *supra* note 171, at 175.

214. STAMP, *supra* note 171, at 40. For a discussion of Spillers & Bakers's extraordinary profits, see *supra* text accompanying note 174. Conspicuous consumption led to extremely high personal income tax rates during the war. The British press bemoaned " 'the Asquith wedding of 1915, which was so awkward a stumbling block in the way of preachers of economy for many

his first radio address after the outbreak of WWII, long before Pearl Harbor, he declared that "'no American has the moral right to profiteer at the expense either of his fellow-citizens or of the men, women, and children who are living and dying in the midst of war in Europe,'"[215] and he later swore that "not a single war millionaire would be permitted as a result of the war disaster."[216] The EPTs may have played an important role in obtaining organized labor's cooperation in working overtime to produce as much as possible for the war effort. "It was stated that [an excess profits] tax would be a most important factor in mollifying labour, for one of the greatest causes of unfortunate trade disputes was the feeling of the men that their masters were filling their pockets."[217] "'A profits tax would do more to increase production than anything else could do.'"[218]

While public policy usually does not concern itself with mollifying envy, and standard economics does not model the effect of *A*'s wealth on *B*'s happiness,[219] the world wars involved mass conscription, rationing, and other extreme measures. Thus, politicians may have calculated rationally that EPTs were necessary to hold together the social fabric. High transaction and administrative costs may have made a theoretically more attractive windfall profits tax infeasible. There may have been no choice consistent "with both good morals and good economics, to prevent, as far as possible, the enrichment of business and business men through the calamity of war."[220] Thus, the EPTs may have been defensible as the best alternative in an imperfect world.

ii. *The Windfall Profit Tax on Oil*

The Windfall Profit Tax on Oil, in contrast to the wartime EPTs, stands as a relatively efficient tax on unearned windfalls. While ultimately caused by the successful 1973 oil embargo by the Organization of Petroleum Exporting Countries (OPEC), the roots of the tax begin with economy-wide

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months afterward,'" and similarly railed against a ball given by Lady Curzon in 1917 that was "'beautifully done and extremely smart.'" LA FOLLETTE, *supra* note 168, at 19 (citing *The Loan and the Moral*, ECONOMIST, Mar. 3, 1917, at 424).

215. CURRAN, *supra* note 171, at 174 (quoting *Text of Address by the President*, N.Y. TIMES, Sept. 4, 1939, at 6).

216. RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 263 (1954).

217. STAMP, *supra* note 171, at 51.

218. *Id.* at 147 (quoting Sir A. Markham, M.P.); *see also* Note, *Mobilization for Defense*, 54 HARV. L. REV. 278, 311 (1940) (stating that Congress passed the EPT on the eve of WWII in large part to protect the morale of laborers, consumers, and draftees from high wartime profits by industry).

219. For a comprehensive overview of the limited economic literature examining models in which people's welfare depends on the welfare of others, see Richard H. McAdams, *Relative Preferences*, 102 YALE L.J. 1 (1992).

220. KAHN, *supra* note 193, at 22.

wage and price controls imposed by executive order in 1971.[221] While most controls soon ended, the government continued to regulate oil prices in the wake of OPEC's successful cartelization in 1973 and thereafter. For the duration of the 1970s, domestic petroleum prices remained below world levels by governmental fiat.[222]

Artificially low domestic petroleum prices only exacerbated the energy crisis by encouraging consumption and discouraging domestic exploration.[223] These adverse incentives created a growing chorus for price deregulation, and the government eventually responded.

> In 1979, President Carter announced a program to remove price controls from domestic oil by . . . 1981. By eliminating price controls, the President sought to encourage exploration for new oil and to increase production of old oil from marginally economic operations. He recognized, however, that deregulating oil prices would produce substantial gains (referred to as "windfalls") for some producers. The price of oil on the world market had risen markedly, and it was anticipated that deregulating the price of oil already in production would allow domestic producers to receive prices far in excess of their initial estimates. Accordingly, the

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221. *See* Dennis B. Drapkin & Philip K. Verleger, Jr., *The Windfall Profit Tax: Origins, Development, Implications*, 22 B.C. L. REV. 631, 639 (1981).

222. For a more detailed history of the Windfall Profit Tax on Oil, see *id.* The lynchpin regulatory measure to deal with the huge disparity between domestic and world market oil prices created by the price freeze on petroleum was the Emergency Petroleum Allocation Act of 1973, 15 U.S.C. §§ 751-756 (repealed 1975). This Act "established a mechanism for allocating the benefits of lower-cost price-controlled crude oil equitably throughout the country—not by physically allocating oil, but by a system of cash transfers among the refiners based upon their relative access to such oil." Texaco v. Department of Energy, 795 F.2d 1021, 1023 (Temp. Emer. Ct. App. 1986). For a summary and analysis of the Act, see Note, *National Energy Goals and FEA's Mandatory Crude Oil Allocation Program*, 61 VA. L. REV. 903 (1975).

223. Price controls are one way to capture windfalls—indeed, they are more precise than general taxation in redistributing gains from lucky winners to losers. As experience with oil price controls showed, however, the misallocative effects of price controls are significant.

To highlight these misallocations, consider another context giving rise to frequent complaints of windfalls: hardware stores charging high prices for everything from flashlights to shovels in the wake of a natural disaster such as a hurricane. If the store owner cannot raise prices in the short run (before additional supplies can arrive), then someone may wander in and buy the last flashlight to use as a nightlight for a mildly scared child, while the next person to rush in may need one to search for survivors in a collapsed building. A higher price signals less needy users to forgo consumption in favor of those in greater need. Contrary to popular belief, then, raising prices in the wake of a disaster is not price-gouging—indeed, it may save lives. In the long run, of course, we rely on higher prices to encourage greater production of flashlights (eventually driving price back down to cost). If the natural disaster were truly an unprecedented surprise, and if it were administratively feasible, the state might enact a windfall profits tax on hardware stores after the fact. Price regulation, however, is a foolhardy substitute.

These observations apply with equal force to one popular form of price regulation: rent control. While temporary, surprise housing shortages make the strongest economic case for barring landlords from raising rents, *see* ANTHONY DOWNS, RESIDENTIAL RENT CONTROLS: AN EVALUATION 1-2 (1988), such regulations mean, for example, that some families will retain excessive space, while others in great need may have to look far afield.

> President proposed that Congress place an excise tax on the additional revenue resulting from decontrol.[224]

The Court properly labeled the measure an excise (sales) tax; in spite of its title, the Act did not (at least directly) tax profits.[225] The Windfall Profit Tax on Oil (WPTO) taxed producers on a percentage of the difference between the market price of each barrel they sold and some base price defined in the statute. This avoided the difficulty of defining the "normal" profits of oil producers, a problem that, as outlined above, plagued the wartime EPTs.[226]

The definition of base prices and the varying percentage tax rates were designed to create incentives for producers to explore for new domestic sources of oil. Generally speaking, oil from older wells (those predating the OPEC embargo) had both a lower base price (and so a greater portion of the price was taxable) and higher tax rate (up to seventy percent). The statute also contained a variety of complicated exceptions and exemptions for oil that was expensive to find and extract.

The Act was explicitly "designed to impose relatively high tax rates where production cannot be expected to respond very much to further increases in price and relatively low tax rates on oil whose production is likely to be responsive to price."[227] The Act, then, aimed to tax most heavily oil stocks discovered before the surprising OPEC embargo, while taxing more recent and future discoveries less heavily or not at all. This is precisely analogous to the efficient (though perhaps infeasible) alternative to the wartime EPTs discussed earlier.[228] The WPTO targeted windfalls accruing to those lucky enough to be sitting on large stocks of oil when OPEC surprised everyone by raising the world market price of oil dramatically during the 1970s.[229] As discussed in Part II, the windfall gains of domestic producers charging OPEC-inflated prices were both an efficient

224. United States v. Ptasynski, 462 U.S. 74, 76 (1983) (holding that the Crude Oil Windfall Profit Tax Act of 1980 did not violate the Constitution's Uniformity Clause, *see* U.S. CONST., art. I, § 8, cl. 1) (internal citations omitted).

225. *See* Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229-308. To the extent that the incidence of the tax fell on producers (that is, insofar as they could not shift the tax onto their customers), as primarily appears to have been the case, the tax ultimately did reduce profits instead of raising prices.

226. *See supra* notes 189-195 and accompanying text.

227. H.R. REP. NO. 96-304, at 7 (1979), *cited in Ptasynski*, 462 U.S. at 77; *see also* S. REP. NO. 96-394, at 6 (1979). "It is easy to see why a windfall profits tax on oil, for example, might be best applied to oil already extracted, with future oil exempted." Levmore, *supra* note 12, at 273 n.16.

228. *See supra* text accompanying note 211.

229. An external cartel benefits domestic producers in ways similar to a tariff: A cartel maintains an artificially high price worldwide, while a tariff maintains an artificially high price domestically. Economists have long argued that industries benefiting from tariffs (if there must be tariffs) should pay some sort of windfall profits tax. *See, e.g.*, CURRAN, *supra* note 171, at 3.

source of tax revenue and a desirable form of sharing risk with a population facing higher energy prices.[230]

On the plausible assumption that nobody foresaw that OPEC would try to limit worldwide oil production, let alone succeed,[231] the WPTO taxed gains nobody expected. By limiting the levy to existing stocks, the government had no need to face the difficulty of adjusting the tax for the riskiness of the different enterprises. As windfalls, the gains of domestic producers due to OPEC's success were all risklessly obtained.

Although the WPTO was free of many difficulties that faced the wartime EPTs, it was not perfect. Because base prices did not reflect real-world costs precisely, experts estimate that the tax did discourage a modest amount of cost-effective domestic production.[232] And while it seemed a less ambitious tax than the wartime EPTs, governing previously discovered oil rather than present and future production of, and investment in, virtually everything, one government study declared that the WPTO was "perhaps the largest and most complex tax ever levied on a U.S. industry."[233] Estimates put the administrative costs of the WPTO at $115 million a year.[234]

Despite these imperfections, in the main the WPTO performed admirably. Economists seem united in believing that, given a world price for (competing) oil that domestic producers could not affect, the producers

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230. It is important to note that, to the extent that all citizens own a diversified portfolio of stocks, they would to some extent share in many windfalls such as that experienced by oil producers in the wake of OPEC. What people lost at the gas pump, they would gain back in their mutual funds and pension plans. Diversified investing, however, is unlikely to make windfalls a wash. The windfall may occur in an industry largely in private hands, concentrating the gain in relatively few hands. This was the case with the oil industry in the 1970s and 1980s, when independents produced roughly half the nation's annual oil output. *See* William P. Streng & Mark W. Romefelt, *Structure of the Windfall Profits Tax*, *in* PRACTICING LAW INST., WINDFALL PROFITS TAX 11, 17-18 (William P. Streng ed., 1980). In addition, of course, wealth is not perfectly distributed. The wealthy own stocks disproportionate to their numbers; relying on individual portfolios to spread windfalls is thus regressive.

231. The standard assumption in economics is that price-fixing cartels are unstable, since, in the absence of some enforcement mechanism, each supplier has an incentive to produce and sell more, reducing prices. *See* NICHOLSON, *supra* note 15, at 449. OPEC did eventually succumb to this "law" of economics, but only after a number of years, during which the cartel soaked billions of dollars from the U.S. economy. *See* Salvatore Lazzari, *Should the Windfall Profits Tax Be Reinstated?*, 48 TAX NOTES 1695 (1990).

232. "Over its eight-year life span, the windfall profits tax reduced domestic oil production by between three and six percent, depending on the price elasticity of oil supply." Lazzari, *supra* note 231, at 1695. The main source of disincentives were base prices that discouraged additional development of existing oil fields. *See Impact of Windfall Profits Tax Repeal on U.S. Production Outlined in DOE Study*, PLATT'S OILGRAM NEWS, Oct. 19, 1987, at 6.

233. GAO, ADMINISTRATION OF THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980 (1984), *quoted in* Lazzari, *supra* note 231, at 1695.

234. It cost the federal government $15 million per year to administer the tax and cost private industry $100 million a year to comply. *See Oil Producers Win in Windfall Profits Tax Repeal*, UPI, Apr. 1, 1988, *available in* LEXIS, News Library, WIRES File.

were unable to shift the tax onto consumers.[235] Hence, the WPTO hit its target. The windfall captured by the tax was huge—roughly $44 billion.[236] This was not the entire windfall, but it was close: "[T]he tax recouped about three-fourths of the windfalls that accrued to the U.S. oil industry."[237] At the appropriate moment, the tax died a natural death. By 1986, OPEC's price-fixing regime began to fall apart. Market prices declined below the base prices of the WPTO and thus producers owed no taxes. Congress repealed the tax in 1988.[238] Given the effectiveness of the WPTO, some politicians have called for its reinstatement if and when the OPEC cartel again effectively limits production and raises prices. When OPEC did just that in the summer of 1990, for instance, one congressman declared that "[w]indfall profits generated by . . . price gouging at the expense of consumers are intolerable and should be taxed."[239]

The windfall justification for special taxation, however, only works once. The world oil markets did seem largely surprised by OPEC's successful cartelization in 1973. Few if any investment and exploration decisions contemplated skyrocketing oil prices. Since the first oil shock, however, OPEC has remained a fundamental source of risk in the oil market.[240] Thus, while a successful OPEC may indeed boost the profits of domestic oil producers, "just as sure, the industry might suffer windfall losses when OPEC decides to help drive oil prices downwards, as happened in 1986."[241] OPEC is now part of the oil market landscape, and it is positively desirable that oil producers weigh the cartel's effects in their exploration and investment decisions. For instance, post-OPEC, it may well

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235. For a conventional static analysis showing that producers, not consumers, paid the WPTO, see Stephen L. McDonald, *The Incidence and Effects of the Crude Oil Windfall Profit Tax*, 21 NAT. RESOURCES J. 331, 336-39 (1981). There followed between McDonald and Dale Lehman a rather involved debate over the relative merits of this simple static model and a more complex dynamic exhaustible resource model of the oil market. *See* Dale E. Lehman, Reader Response, *A Reexamination of the Crude Oil Windfall Profit Tax*, 21 NAT. RESOURCES J. 683 (1981); Stephen L. McDonald, Reader Response, *The Incidence and Effects of the Crude Oil Windfall Profit Tax: A Reply to Lehman*, 21 NAT. RESOURCES J. 690 (replying to Lehman); Dale E. Lehman, Reader Response, 22 NAT. RESOURCES J. 275 (1982) (offering a rejoinder to McDonald); Stephen L. McDonald, Reader Response, 22 NAT. RESOURCES J. 277 (1982) (providing a riposte to Lehman).

236. The Congressional Research Service found that, over its lifetime, the tax raised $77.7 billion in gross revenue (roughly $126 billion in current dollars) but only $43.7 billion in net revenue (roughly $71.7 billion in current dollars), since producers could deduct WPTO payments on their regular income tax returns. *See Oil Producers Win in Windfall Profits Tax Repeal*, *supra* note 234. Current dollar calculations are based on the Consumer Price Index for All Consumer Goods, seasonally adjusted, U.S. average, for all items, Bureau of Labor Statistics series I.D. no. CUSR0000SA0, available at http://www.bls.gov.

237. Lazzari, *supra* note 231, at 1695.

238. *See* Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1941, 102 Stat. 1107, 1322-24.

239. Silvio O. Conte, . . . *Or Tax Excess Profits*, N.Y. TIMES, Sept. 10, 1990, at A23.

240. *See* Lazzari, *supra* note 231, at 1696.

241. *Id.*

be rational for domestic producers to look for oil that would cost, for example, $75 a barrel to extract, even though the market price has never exceeded $40 a barrel, and has, for the most part, fluctuated between $10 and $25 for the last decade.[242] Such expensive oil might become attractive if a reinvigorated OPEC managed to drive the price of oil above $100 a barrel. Companies will not undertake such socially desirable exploration, however, if the government stands ready to tax away the profits that only foresight made possible. Windfall taxation makes sense only when gains are due to true surprises, and events are usually surprises only the first time market participants encounter them.[243]

The lesson is that windfall taxation should be imposed judiciously, as true surprises are uncommon and by definition are not recurring events. Britain's Labour government apparently has yet to learn this lesson. It recently imposed a windfall profits tax on privatized utilities that made record profits after the previous Tory government sold them to investors.[244] Advocates did not point to a surprise that justified the tax; it seems that either the government charged too little for the utilities when it sold them,[245] or that regulators authorized excessive rate increases. The only surprise in this case was the decision to impose a tax, and even that has come back to haunt the government. When officials began the process of privatizing railways, before the imposition of the windfall tax on utilities, municipalities warned "that a windfall tax on water and electricity would undermine the prospects for future privatisations."[246] Bidders will reduce their offers to reflect (discounted) expected future windfall profits taxes.[247]

The folly of the utility tax led some commentators to issue overly broad condemnations of all windfall taxation. For instance, the claim that, "[s]ince they are applied retrospectively, windfall taxes are inherently

242. *See WTI Crude Monthly Averages* (visited March 1, 1999) <http://www.wen.co.za/wen/charts/oil/comawt.htm>.

243. In theory, a windfall tax on domestic oil discovered before 1973 but still in the ground would be sensible. After 25 years, a large portion of domestic reserves consists of later discoveries. As time goes on, it becomes increasingly difficult to determine which fields and what percent of each field were discovered before 1973.

244. *See* Michael Prescott, *Power Firms Face £2.5 Bn. Windfall Tax*, SUNDAY TIMES (London), Sept. 24, 1995 (discussing the political clamor for the tax); *U.K. Utilities Hit by "Windfall" Taxation Plan*, OIL & GAS J., July 14, 1997, at 27 (discussing enactment of the tax by the new Labour government).

245. One official drew the following analogy: "If you sell a house and three years later you regret the price you sold you have no right to say you should change the terms of the contract." Peter Rodgers, *City Antipathy Fuelled by Fear and Loathing*, THE INDEPENDENT (London), Sept. 27, 1995, at 2 (quoting Adair Turner).

246. *Id.*

247. The government may fool them once, but investors are likely to catch on to patterns of governmental behavior that affect returns and capitalize them into prices. Thus, the government cannot rely on surprise as a long-term policy tool. *See* Finn E. Kydland & Edward C. Prescott, *Rules Rather than Discretion: The Inconsistency of Optimal Plans*, 85 J. POL. ECON. 473 (1977); R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23 REV. ECON. STUD. 165 (1955-1956).

unfair,"[248] is untenable. As discussed in Part II, the government can put the world on notice that when it detects unearned rents, it will tax them. While it is generally true that, "if people come to believe that when they make money the state may arbitrarily snatch a large part of it, they will not work as hard,"[249] windfalls by definition are not the fruits of effort or enterprise. Thus, taxing them creates no disincentive effects.[250]

b. *Progressive Income Tax*

Windfall profit taxation need not focus on one product or industry. Comparing the celebrity status and huge incomes commanded by some Olympic gold medalists with the return to anonymity suffered by other world-class athletes, one commentator argues that luck often plays a significant role in personal income: "[W]hen it comes to income, skill and hard work seem to play only a moderate role."[251] While it seems unlikely that income earned by a minimum-wage manual laborer is due to any sort of windfall, Olympic athletes, business executives, and others earn much more than competitors with similar skills and dedication, and the difference may be due to luck. To the extent this is true, then "even from a standpoint of efficiency (much less equity), a progressive tax may not be so bad after all."[252]

The role of luck in personal income, however, is much less clear than the role of luck in specific events, such as OPEC's effect on the oil market. It is difficult to determine the effect of a steeply progressive tax on effort and enterprise, but the disincentives may be significant.[253] And reward mechanisms that give rise to huge income discrepancies based on seemingly small differences in performance may be rational means to induce maximal effort from a pool of employees. The theory of tournaments suggests that corporations pay CEOs huge salaries to induce extraordinary effort from scores of senior vice presidents hoping to be the

248. *Britain: Chasing Windfalls: Taxation*, ECONOMIST, June 14-20, 1997, at 61.

249. *Id.*

250. Despite its absolutist tone, the *Economist* editorial admits that banks earned "genuine windfalls" when the government tightened monetary policy in 1980 and thus they defend a windfall profits tax on those gains. *See id.* They distinguish this episode from the utilities tax by noting that "the circumstances appeared unusual" for the banks, but not for the utilities. *Id.* This simply may be another way of saying that the banks experienced higher profits due to a complete surprise (and hence received a windfall), while the utilities earned their higher profits by effort and enterprise (and hence, under this Article's definition of the term, did not receive a windfall). *See id.*

251. Steuerle, *supra* note 11, at 1197.

252. *Id.* at 1198.

253. *See* Jerry A. Hausman, *Labor Supply*, *in* HOW TAXES AFFECT ECONOMIC BEHAVIOR 27 (Henry J. Aaron & Joseph A. Pechman eds., 1981); Jerry A. Hausman & James M. Poterba, *Household Behavior and the Tax Reform Act of 1986*, 1 J. ECON. PERSP. 101 (1987).

next occupant of the top perch.[254] Thus, efficiency considerations weigh both for and against progressive taxation: Such taxes undoubtedly capture some lucky windfalls, but also create disincentives and hence deadweight losses. More controversial fairness arguments may be necessary to tip the scale in favor of progressive taxation.

c. *Intestacy and Escheat*

One of the earliest uses of the term windfall was to describe receipts of inheritance, and commentators continue to so view the gains of beneficiaries under wills.[255] While an inheritance is often (though not always) unearned, the proper focus of an efficiency analysis is on the granting decedent, not the grantees. People are under no obligation to die with assets; they can annuitize their net wealth at some advanced age and thus ensure they leave nothing at death. Yet most choose to leave estates large relative to their average incomes and to draft wills directing every detail of the distribution of all of this wealth upon their deaths. This behavior indicates that making gifts upon death has great utility to most people. Taxing away bequests would cause devisers to alter their behavior and leave less wealth via wills. People might work less hard, which is often undesirable from a societal point of view. They would likely engage in other behavior generally thought undesirable, such as consuming instead of saving or making charitable donations.

When there is no will—an instance of intestacy—there are fairly strong grounds to presume a certain indifference on the part of the deceased. Most states, however, do not expropriate the estate when blood relations survive the intestate decedent,[256] presumably under the theory that almost everyone means to leave their worldly possessions to such relatives and the absence of a will is a mere oversight. Thus, the law, as it so often does, implies likely default provisions where a decedent neglects to make a will.

If a decedent has no living relations, the government effectively taxes the estate at 100% under the doctrine of escheat. Taxing wealth that the owner basically abandoned at death creates little, if any, disincentive for the living—if they are working hard to provide someone with an inheritance,

254. The seminal work on tournaments as compensation systems is Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981). The seemingly inordinate rewards garnered by Olympic gold medalists compared to all other competitors may play the same role, motivating all contestants to practice harder and longer, and thereby producing a better competition in general. Steuerle seems to contemplate this possibility when he admits that "the potential of large rewards may compel some to work harder than ever." Steuerle, *supra* note 11, at 1197.

255. *See supra* note 2 (citing use by Erasmus in *Apophthegmes*). For a similar modern-era characterization, see Plehn, *supra* note 177, at 283 ("Inheritance may be regarded as something unexpected and of the nature of a windfall . . . .").

256. *See* WILLIAM M. MCGOVERN, JR. ET AL., WILLS, TRUSTS AND ESTATES 17-18 (1988).

they know that they need only write a will. Thus, intestate estates form an attractive target for windfall taxation, and the modern law of escheat has a long pedigree. Adam Smith listed a series of intestacy taxes,[257] and Bentham advocated a 100% tax in cases of intestacy where there were no close surviving relatives.[258] Bentham's position foreshadowed a trend toward curtailing windfalls for distant "laughing heirs," who receive surprise inheritances from, for example, fifth cousins they never even knew existed. The Uniform Probate Code and a growing number of states look only as far as cousins (and their issue) when they distribute intestate estates.[259]

While this expansion of escheat seems efficient, other recent innovations of the doctrine are questionable. For instance, section 2(a)(1) of the Uniform Unclaimed Property Act extends escheat to unredeemed travelers checks and a host of modern financial devices, such as unclaimed insurance proceeds, utility deposits, etc.[260] At first blush, it might appear that unredeemed travelers checks are a windfall to issuers, but in a competitive market they will have to pass on this saving to purchasers. This market solution spreads the risk of forgetting about travelers checks over the subgroup of consumers who purchase travelers checks: Returning the windfall to those who create it, instead of the entire population, reduces costs, and thus encourages the use of travelers checks. This is analogous to returning lost goods to their true owners.

3. *Insider Trading*

In contrast to the time-honored use of escheat to capture hereditary windfalls, the laws against insider trading are a recent development.[261] That insider trading was legal at common law is one factor cited to support arguments that the practice is efficient.[262] Yet just as assessing a windfall profits tax would have been administratively impossible before nations

257. *See* 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 386-87 (Edwin Cannan ed., Univ. of Chicago 1976) (1775-1776).

258. *See* 1 JEREMY BENTHAM'S ECONOMIC WRITINGS 283 (W. Stark ed., 1952).

259. *See* UNIF. PROBATE CODE § 2-103 (amended 1990), 8 U.L.A. 1 (1998) (adopted in 14 states). At least three other states that have not adopted the Code have nonetheless followed its lead and have limited the remoteness of relatives who take in cases of intestacy. *See* KAN. STAT. ANN. § 59-509 (1997); OR. REV. STAT. § 112.017 (1997); WASH REV. CODE ANN. § 11.04.015 (West 1998).

260. *See* UNIF. UNCLAIMED PROPERTY ACT § 2(a)(1) (amended 1995), 8B U.L.A. 89 (Supp. 1998).

261. The United States had no federal securities laws until Congress enacted the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1994), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78*lll* (1994). The Securities and Exchange Commission did not promulgate Rule 10b-5, the provision used to police insider trading, until 1948. *See* 17 C.F.R. 240.10b-5 (1998).

262. *See* Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities and Exchange Commission, 13 HOFSTRA L. REV. 127, 135 (1984).

possessed extensive revenue collection apparatus, so too regulating insider trading would have been extraordinarily difficult, if not impossible, before the advent of extensive securities market regulation. Under the common view, insider trading can result in unearned windfalls, and hence regulation is clearly desirable.[263] To the uninitiated, then, the assertion that insider trading is a desirable, efficient activity may seem fatuous. Yet serious scholarship offers two grounds for returning to the common-law rule allowing insider trading.

The first contention is that insider trading is an efficient form of executive compensation.[264] Executives may try to free ride on each others' efforts; to the extent that it is difficult to separate out individual contributions to a company's success, there may be insufficient incentives for effort and enterprise. One way to reward producers of new ideas is to permit insider trading: "[T]he manager can immediately 'renegotiate' his compensation package by purchasing shares.... [I]nsider trading is the only compensation scheme that allows immediate and costless renegotiation whenever managers believe that they have the opportunity to develop valuable information."[265]

Ross raises a powerful objection to insider trading as a form of executive compensation: Shareholders will have little, if any, control over the size of insider trading profits and thus the agents (instead of the principal) set their own wages. Thus, this form of compensation invites executives to appropriate large rents without monitoring by other corporate officials, shareholders, or the market.[266] And the fact that shareholders and potential shareholders might have a rough idea of the level of insider trading and discount the price they are willing to pay for shares does not justify the practice: A known level of criminal embezzlement would have the same effect yet is clearly undesirable.

In addition to citing the common-law rule permitting insider trading in support of the practice's efficiency, Fischel notes that during this period of legality firms did not enact charter provisions barring insider trading by

263. This Subsection addresses the more difficult case of insider trading on positive information likely to increase share prices. Rules against insider trading on negative information are universally endorsed: Manufacturing bad news is much easier than manufacturing good news, and if corporate executives could make money by trading in advance of bad news, the perverse incentives would be overwhelming.

264. *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 131-45 (1966); Fischel, *supra* note 262, at 132. This justification applies only to "classic" insider trading—trading by executives in the shares of their employer. It cannot justify insider trading by, for example, printers, *see* Chiarella v. United States, 445 U.S. 222 (1980), or by lawyers representing an acquirer who trade in shares of the target, *see* United States v. O'Hagan, 521 U.S. 642 (1997).

265. Fischel, *supra* note 262, at 132.

266. *See* Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177, 184 (Franklin R. Edwards ed., 1979).

their own executives.[267] This he takes as further evidence of the efficiency of insider trading. By the same token, however, it is possible for firms today to simulate insider trading as a form of executive compensation. Employers could stand ready to write any and all call options requested by executives, giving them the right to buy however many shares desired, at some price above the stock's current market price, lasting for however long the executives think it will take for some new idea to translate into a higher stock price. If necessary, companies could avoid securities regulation of these transactions by making the mechanism entirely derivative: Option purchases could be made as mere accounting entries, and all settlements could be paid in cash instead of shares. If insider trading is indeed an efficient form of compensation, one would expect to observe such schemes often; yet I have uncovered not a single reference to such a contract in the extensive literature on executive compensation.

The second argument used to defend insider trading is that it causes stock prices to reflect all available information, instead of just public information, and hence leads to more accurate and efficient pricing of shares.[268] It is not at all clear, however, that personal trading by one or a few parties trying to remain anonymous will move the market. If everyone else in the market believes that the risk/reward profile of a company has not changed, then any temporary upward pressure on its share price should bring additional shares to market since the price now looks "too high" given public information about the company, which by assumption has not changed.[269] And even if insider trading does move the market, there is a simpler objection: It seems just as easy to move the market even faster by requiring full disclosure before insiders may trade.[270]

Thus, it is doubtful that insider trading is beneficial, either as a form of executive compensation or as a method to factor all information into stock prices. The more difficult question is: In the vast, anonymous stock market, who is harmed by insider trading? As noted previously, to the extent market participants have a rough sense of the level of insider trading, they will discount the price they pay for shares. Thus, in general, insider trading does not affect returns, but it does make it more expensive for firms to raise equity capital. A few definite victims are identifiable. First, those who trade frequently without inside information will, over the run of transactions,

267. *See* Fischel, *supra* note 262, at 135.

268. *See id.* at 140-42.

269. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 629-34 (1984). This argument does not hold if the market knows that insiders, or others likely to possess superior information, such as arbitrageurs warehousing shares, are trading; such trades amount to new information that will lead to a permanently higher price.

270. *See id.* at 632; Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988).

accumulate losses when they trade with better-informed parties.[271] Second, somewhat paradoxically, non-insiders with comparatively good information also lose out to insiders.[272] More generally, anyone unlucky enough to trade when insiders are buying up shares based on nonpublic information may be characterized as a victim of insider trading.[273]

While none of these victims, taken alone, seems particularly sympathetic, thinking in terms of windfalls provides a more powerful argument for strictures against insider trading. If insider trading is legal, a few insiders receive large, unearned windfalls,[274] while large numbers of anonymous investors end up modestly poorer. From a sufficiently remote ex ante perspective, nobody knows who is going to be lucky enough to stumble across inside information, and thus this reward structure looks like a lottery that risk-averse investors will find unattractive. Forbidding insider trading spreads gains more broadly and hence is yet another form of reverse insurance. In addition, government recoupment of insider trading profits—windfalls—by civil and criminal prosecutions is an efficient way to raise revenue.

C. *State Paying Minimum Price Necessary To Induce Desired Behavior*

The previous Section considered scenarios in which individuals received windfalls and the state then captured the gain. This Section examines formally distinct, though substantively similar, situations where individuals possess items that are of special value to society or are in a good position to take some action that benefits society. Instead of capturing windfalls in these cases, the government prevents windfalls from occurring in the first place by paying no more than is necessary to compensate the owner or to elicit desired behavior. Thus, instead of one lucky windfall recipient retaining a large gain due to a change in public demand for an item or activity that the recipient did not anticipate or plan for, society as a whole shares in the windfall.

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271. *See* David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1457 (1986).

272. *See id.* at 1459.

273. This statement must be qualified, since determining whether a particular trader is a "loser" depends on particular circumstances. For instance, a shareholder liquidating her entire portfolio to raise cash for some pressing expenditure would have traded even with full knowledge—though she would have received a higher price had the insider made disclosure. A shareholder selling only a small portion of her portfolio, on the other hand, might have held onto her shares had she known they were likely to rise in value.

274. This conclusion rests on the previous analysis demonstrating that insider trading is not a sensible form of executive compensation and that it does not serve the social purpose of efficiently pricing securities. *See supra* text accompanying notes 271-273.

1. *Why Just Just Compensation?*

When the state buys property from its citizens, it (like any other buyer) attempts to minimize the purchase price. As long as there is an active market, with multiple competing sellers, the government has no need to use its power of eminent domain. When the government is trying to buy a specific piece of property, however, it is in a bilateral monopoly with one landowner.[275] As discussed previously, there may well be a wide range of prices in which both parties would be happy to contract, and they are likely to waste time, effort, and resources fighting for favorable terms.[276]

The law of just compensation provides a simple solution: The government is required to pay market price and only market price.[277] Though the Just Compensation Clause is traditionally viewed as protective of property rights, this is only half true. While it does prevent the government from seizing property without any payment, it in effect mandates that the government gets all the gains from trade with citizens. Property owners may hold out for any price they like with other buyers, but the government pays only that price that the property would reach at a fair and open auction.

There are two reasons why this rule is efficient. First, the situation is precisely analogous to the private bilateral monopolies discussed previously.[278] The value of the property to the government—the benefit society will reap from the public project—is difficult to gauge. It certainly exceeds market value, since that is what the government must pay. The value of the property to the government also likely exceeds any supra-market, or subjective, value attached to the property by the owner. Policymakers can thus minimize transaction costs by giving the party likely to value the property more highly—here, the government—the right to buy at market value.

Second, paying anything more than market price would result in windfalls for those lucky enough to own property needed for public projects, at the expense of the rest of the population, who would have to pay higher taxes to fund higher compensation. "[T]o permit recovery of value that is not created by fair, open market conditions would be to award a few

275. *See* POSNER, *supra* note 39, at 62, 68-72.

276. *See supra* text accompanying note 85.

277. For the leading federal case limiting just compensation to market value, see *United States v. Miller*, 317 U.S. 369 (1943). Two states, Florida and Georgia, deviate from this prevailing rule and require the state to award property owners a portion of the gain due to a public project. *See* Department of Transp. v. Nalven, 455 So. 2d 301 (Fla. 1984); Calhoun v. State Highway Dep't, 153 S.E.2d 418 (Ga. 1967) (declaring the rule established by *Hard v. Housing Authority*, 132 S.E.2d 25 (Ga. 1963), constitutionally compelled, and hence not alterable by statute). *See generally* 3 SACKMAN, *supra* note 72, § 8A.02[3] (describing the minority view that an enhancement attributable to a proposed public project is recoverable).

278. *See supra* text accompanying note 85.

private propertyholders windfall gains solely because of public needs and exigencies."[279] To finish what is by now a familiar argument, risk-averse people will find such an eminent-domain lottery unattractive; their expected wealth is equal in each case and would vary less in a world with lower taxes and market value compensation than in a world with higher taxes and supra-market compensation.

What if news of the government's plans leaks out and a speculator buys a key piece of property at a price above the existing market price but below the value of the land to the government? This roughly describes the facts of *United States v. Cors*,[280] in which the Supreme Court held that when the government condemned boats for use in World War II, the Just Compensation Clause required the government to pay only the lower prices reflecting market conditions before expectations of war increased prices. While *Cors* seems consistent with the rule excluding government-created value from just compensation awards, Richard Posner notes some complications.

Posner asks if it should make a difference whether the government requisitioned the boats from people who owned them before the market price began to rise or from those who bought them from the previous owners at the current high price.[281] He writes:

> This question brings out the administrative complexity of trying to base just-compensation law on an aversion to windfalls. Much, maybe most, of the property the government takes has benefited from government expenditure. A conspicuous example is land reclaimed from a lake or river by the Corps of Engineers—but there is a sense in which all privately owned land benefits from the public expenditures on maintaining law and order, a title-recording system, etc. The benefits may long ago have been impounded in the price of the land, however, so that payment of full compensation will confer no windfall to anyone. And why confiscate just condemnees' windfalls?[282]

Posner seems to find *Cors* a close call; on the one hand he notes that the holding prevented "a capricious wealth distribution from taxpayers to boat owners," but on the other hand it seems to lead to the government "taking too many boats, because it will not consider the competing needs of the remaining private customers for boats."[283]

279. United States v. 320.0 Acres of Land, More or Less, 605 F.2d 762, 782 (5th Cir. 1979).
280. 337 U.S. 325 (1949).
281. *See* POSNER, *supra* note 39, at 65.
282. *Id.* at 65-66.
283. *Id.* at 65.

Posner raises four distinct issues. First, there would be unbelievable "administrative complexity" in trying to capture all windfalls due to value created by government acts.[284] Of course, to the extent that all citizens benefit roughly to the same degree, the presumption is that they did pay for the service via taxes of one stripe or another. Moreover, as emphasized in Part II, capture is only worth pursuing in cases of easily identifiable windfalls of significant size. In the context of condemnation, for instance, it seems worthwhile to discount the large effect of war demand but pointless to capture minimal windfalls due to the existence of a recording system, for which the property owner has paid, again, via income or property taxes.

Second, Posner points out that some owners, like our speculator, will have paid relatively high prices reflecting the government's planned use.[285] As discussed in Part II, however, the government can in effect put the citizenry on notice that it stands ready to tax away windfalls. The speculator then should have known that, per *Cors*, he should not pay a price that reflects a windfall to the seller. The windfall tag, in effect, travels with the assets, so owners cannot capture unearned rents simply by selling the goods to someone else.

Third, Posner notes that to the extent the government pays prewar prices for boats during wartime, it will divert boats from other users willing to pay more and thus, presumably, would put the boats to more valuable use.[286] This economic truism, however, may not apply during a major war. Mass conscription, rationing, and the like seem to give rise to a presumption that the war effort comes first—government demand becomes categorically higher than all other demand.[287] Note too that a high percentage of all private demand was to serve the military activities of the government, and, assuming the government is rational, it will not bid away boats for its direct use that would serve the war effort better in private hands. In wartime, then, we presume the government needs almost everything more than any other user, and thus condemnation at prewar prices to prevent windfalls causes little if any misallocation of resources.

Finally, Posner asks "why confiscate just condemnee's windfalls?"[288] This Article answers that the government *does* capture some other windfalls and *should* capture all windfalls that are ascertainable and large enough to merit the effort. Some of the other windfalls he has in mind are too small or too difficult to identify. Moreover, putting *Cors* in a broader context shows

284. *See id.*
285. *See id.*
286. *See id.*
287. The stakes in World War II could hardly have been higher. When skeptically asked what good resulted from the billions of dollars expended on armaments during the struggle, a Nobel Prize-winning economist replied, "Well, all we got for those outlays was the salvation of western civilization." James Tobin, Seminar on Modern Economics at Yale University (Spring 1984).
288. POSNER, *supra* note 39, at 66.

that windfall capture can occur in surprising ways. The excess profits taxes discussed in Subsection IV.B.2.a.i appeared questionable as a tax on windfalls, but may have been quite sensible as cheap proxies for condemnation. Eminent domain is much more expensive than simply purchasing items in markets. Hence, the government typically employs condemnation power only when no real market exists and transaction costs are high anyway. When World War II caused the price of key assets to rise sharply, the government, per *Cors*, could have condemned all necessary war material at lower prewar prices. Instead, it more often pursued a two-step strategy that achieved substantially the same ends via the cheaper means of (1) market purchases at war-inflated prices, followed by (2) rough capture of the price difference (excess of wartime over prewar prices) via the EPT. One commentator described how the existence of the EPT obviated the need for government agents to drive hard bargains, since they knew the EPT would capture extraordinary profits and return them to the public fisc.[289] Recharacterized as a surrogate for direct condemnation of war supplies, the EPT may have been a quite clever mechanism both to capture windfalls and minimize the transaction costs of obtaining war supplies.

2. *Punitive Damage Awards*

Instead of needing specific property in private hands, the government often wants to encourage behavior that helps enforce the law. Compensatory damage awards, for instance, force people to weigh the costs that their acts impose on others and encourages least-cost avoidance of harms. Thus, the state permits tort victims to sue for compensatory damages in all cases. Tort law permits recovery of punitive damages, however, in relatively limited circumstances.

Economic analysis suggests two situations in which punitive damage awards make sense. First, if a particular type of harmful behavior is difficult to detect, damages must be increased proportionally so that potential wrongdoers, on average, expect to pay for the harm they inflict.[290] For example, treble damages under the antitrust acts reflect the difficulty of detecting and proving collusion in its myriad forms.[291] Second, punitive

289. *See* CURRAN, *supra* note 171, at 57.

290. *See generally* A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869 (1998). Polinksy and Shavell at times seem to argue that this is the sole grounds for imposing punitive damages: "[P]unitive damages ordinarily should be awarded if, and only if, an injurer has a chance of escaping liability for the harm he causes." *Id.* at 874. It seems, however, that they would limit this statement to corporations and other artificial legal entities. They note elsewhere that real persons who commit intentional torts should be liable for punitive damages, even if detection is virtually certain, as it often is for intentional torts like assault. *See id.* at 905-10.

291. Implicit in treble damages is a belief that victims detect only one in three violations. This is a specific example of the general reciprocal rule for calculating punitive damages when

damages are a sensible means of deterring intentional wrongs. Awarding victims of negligence more than compensatory damages will tend to overdeter the productive activity in which the defendant is engaged.[292] When the tort is intentional, however, by definition the defendant was engaged in nonproductive or even counterproductive acts, and thus overdeterrence is not a worry. To the extent that punitive damages deter intentional torts, they save society the cost of the torts and the cost of litigating them.

In either case, punitive damages serve social ends by deterring harmful behavior that is either difficult to detect or completely unproductive. While the legal system must award plaintiffs some damages in order to encourage them to sue wrongdoers and thus deter others from causing harm, judgments in excess of the harm inflicted—compensatory damages—seem unnecessary to induce lawsuits and hence are a windfall.[293] The one antitrust plaintiff in three that detects collusion, for example, collects its actual damages and then twice that sum again. While it is important to assess such a fine against the wrongdoer, there is no reason the award must go to the plaintiff.

Courts have long realized the windfall nature of punitive damages. Over a century ago, one judge found it "difficult to understand why, if the tortfeasor is to be punished by exemplary damages, they should go to the compensated sufferer, and not to the public in whose behalf he is punished."[294] Members of the Supreme Court continue to express puzzlement over the payment of punitive damages to the plaintiff instead of the state.[295] The leading torts treatise avers that "[i]t is generally agreed that

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detection is less than certain: Multiply actual damages by one over the odds of detection. Thus, the lower the odds of detection, the greater the damages assessed against the wrongdoers caught. If plaintiffs detect one in three violations, the rule calls for treble damages; if they detect only one in 10, punitive damages should be 10 times actual damages.

More sophisticated approaches account for additional features of real-world litigation. For example, if the expense and risk of a lawsuit deters some plaintiffs who detect wrongs from suing, the reciprocal rule must reflect this by jacking up damages even higher. *See id.* at 921.

292. *See* POSNER, *supra* note 39, at 227. Thus, assessing punitive damages equal to 10 times actual damages in automobile torts would certainly cause drivers to exercise more care, but probably too much care—possibly to the point of ceasing the activity entirely. Driving is a very productive activity, economically speaking, and excessive penalties for negligence may cost more in precautionary behavior than they garner in reduced accidents.

293. An important assumption here is that compensatory damages do indeed fully compensate victims so that punitive damages are not needed as some sort of ad hoc supplement to bring compensatory damages up to actual damages.

294. Bass v. Chicago & N.W. Ry., 42 Wis. 654, 672 (1877).

295. *See* Smith v. Wade, 461 U.S. 30, 59 (1983) (Rehnquist, J., dissenting) ("Punitive damages are generally seen as a windfall to plaintiffs .... [T]he penalty should go to the State, not to the plaintiff—who by hypothesis is fully compensated."); Rosenbloom v. Metromedia, Inc., 403 U.S. 29, 84 (1971) (Marshall, J., dissenting) ("These awards are not to compensate victims; they are only windfalls.").

punitive damages are a windfall to the plaintiff."[296] There has been a deluge of recent law review commentary condemning punitive damages as a windfall to plaintiffs and calling for reform.[297]

It appears that awarding punitive damages to the plaintiff is a historical/procedural artifact. "Although not meant to compensate a plaintiff, [punitive damages] increase his recovery. He is the fortuitous beneficiary of such an award *simply because there is no one else to receive it.*"[298] The obvious alternative is to award punitive damages to the state. Judges generally have been hesitant about taking such a step themselves.[299] Legislatures in a number of states have passed so-called decoupling statutes that award the state a significant share of punitive damages, ranging up to seventy-five percent.[300] Taxing away the entire punitive damages award, like any 100% tax, would be counterproductive: Plaintiffs would have no incentive to incur the additional expense of litigating for punitive as well as

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296. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 2, at 14 (5th ed. 1984).

297. *See, e.g.*, E. Jeffrey Grube, *Punitive Damages: A Misplaced Remedy*, 66 S. CAL. L. REV. 839, 841 (1993) ("One criticism, the 'windfall theory' of punitive damages, is that punitive damages are an unjust windfall to civil plaintiffs."); James B. Sales & Kenneth B. Cole, Jr., *Punitive Damages: A Relic That Has Outlived Its Origins*, 37 VAND. L. REV. 1117, 1165 (1984) ("[P]unitive damages simply provide a windfall to the plaintiff, penalize the innocent consumers of society, and unnecessarily sap the vitality of the economy upon which society is totally dependent."); James A. Breslo, Comment, *Taking the Punitive Damage Windfall Away from the Plaintiff: An Analysis*, 86 NW. U. L. REV. 1130, 1133 (1992) (stating that "commentators and courts uniformly [maintain] that punitive damage awards amount to a windfall for plaintiffs, who have already been fully compensated by ordinary compensatory damages" (footnote omitted)); Note, *An Economic Analysis of the Plaintiff's Windfall from Punitive Damage Litigation*, 105 HARV. L. REV. 1900, 1907 (1992) ("From the plaintiff's perspective, [a large punitive damage award] amounts to the legal equivalent of a winning lottery ticket."); Lynda A. Sloane, Note, *The Split Award Statute: A Move Toward Effectuating the True Purpose of Punitive Damages*, 28 VAL. U. L. REV. 473, 481 (1993) (finding a "public perception that punitive damages are nothing but a windfall to plaintiffs"); Leo M. Stepanian II, Comment, *The Feasibility of Full State Extraction of Punitive Damages Awards*, 32 DUQ. L. REV. 301, 303 (1994) (advocating "full statutory extraction of punitive damages as a means of taking the windfall of punitive damages away from the plaintiff and compensating society for the injury the defendant inflicted upon it"); *see also* TORT POLICY WORKING GROUP, AN UPDATE ON THE LIABILITY CRISIS 52 (1987) ("[P]unitive damages by their very nature do not serve to compensate plaintiffs. They are a pure windfall, whose only legitimate purpose is to deter truly outrageous and harmful conduct.").

298. Katko v. Briney, 183 N.W.2d 657, 662 (Iowa 1971) (emphasis added).

299. At least one judge has eschewed such passivity and declared that courts have the inherent common-law power, even absent legislation, to divert punitive damage awards from plaintiffs to the state. *See* Fuller v. Preferred Risk Life Ins., 577 So. 2d 878, 886-87 (Ala. 1991) (Shores, J., concurring). Justice Shores elaborated on the theme in Janie L. Shores, *A Suggestion for Limited Tort Reform: Allocation of Punitive Damage Awards To Eliminate Windfalls*, 44 ALA. L. REV. 61 (1992). Her colleagues have seemingly found her arguments convincing. *See, e.g.*, Smith v. States Gen. Life Ins., 592 So. 2d 1021 (Ala. 1992) (using similar reasoning).

300. For a fairly recent collection of citations to state statutes decoupling punitive damage awards, see *BMW of North America v. Gore*, 517 U.S. 559, 617-19 (1996) (Ginsburg, J., dissenting).

compensatory damages.[301] Courts have reached divergent opinions about the constitutionality of these legislative attempts to alter the common law.[302]

This flurry of commentary and legislation has coincided with new theoretical attacks on plaintiffs' punitive damage windfalls. While it is in one sense true that "from the pure perspective of deterrence, the windfall concept is irrelevant,"[303] in that potential defendants are equally deterred by payments to plaintiffs or the state, this ignores the administrative costs of the legal system. There is evidence that litigation costs in a given suit increase with the amount of damages at stake.[304] If so, "[d]ecoupling mitigates the propensity of punitive damages awards to encourage unnecessary litigation, but does not dilute deterrence because defendants' damage payments are unaffected."[305]

This Article's twin reasons for capturing windfalls provide additional grounds for diverting punitive damages from plaintiffs to the state. First, plaintiffs (hopefully) do not make plans to become victims eligible for punitive damage awards, and hence taxing away even a large portion of punitive damage awards will not discourage plaintiffs from bringing suits and deterring difficult-to-detect or intentional torts. Thus, decoupling statutes are an efficient way for the state to raise revenue. Second, in an argument no doubt familiar by now, punitive damage awards ex ante are an unattractive lottery for a risk-averse population. Reliably lower taxes and no chance for a punitive damages windfall offer the same average result as higher taxes and a chance to win the punitive damages lottery, but with greater predictability.

3. *Criminal Windfalls*

The legal system grants windfalls not only to civil litigants in the form of punitive damages, but also to criminal defendants. For instance, even those admitting guilt may escape punishment if the government does not

301. *See supra* notes 198-202 and accompanying text.

302. One state court has held that decoupling statutes violate the Takings Clause, *see* Kirk v. Denver Publ'g, 818 P.2d 262, 273 (Colo. 1991) (holding that a Colorado statute violated the Takings Clauses of the federal and state Constitutions), while others have rejected such challenges, *see, e.g.*, Gordon v. State, 585 So. 2d 1033 (Fla. Dist. Ct. App. 1991), *aff'd per curiam*, 608 So. 2d 800 (Fla. 1992); Shepherd Components v. Brice Petrides, 472 N.W.2d 612 (Iowa 1991). Another court found that a decoupling statute, since it introduced the state into private litigation, violated the Excessive Fines and Due Process Clauses. *See* McBride v. General Motors, 737 F. Supp. 1563 (M.D. Ga. 1990) (holding that a Georgia statute violated the Excessive Fines Provision and Due Process Clause of the Georgia and federal Constitutions). For a decision reaching the opposite conclusion, see *Burke v. Deere & Co.*, 780 F. Supp. 1225 (S.D. Iowa 1991).

303. Thomas C. Galligan, Jr., *Augmented Awards: The Efficient Evolution of Punitive Damages*, 51 LA. L. REV. 3, 58 (1990).

304. *See* Polinsky & Shavell, *supra* note 290, at 923.

305. *Id.*

provide a speedy trial.[306] Perhaps the most well-known criminal windfall is the exclusionary rule. Under the modern interpretation of the Fourth Amendment,[307] courts must exclude evidence obtained by an illegal search or seizure, regardless of how probative it may be of the defendant's guilt.[308] If excluding evidence obtained illegally was the most effective way to deter the police from engaging in illegal searches and seizures, the exclusionary rule would not be a windfall for criminals; it would simply be the (cheapest) price for upholding a constitutional provision.

A growing chorus of critics, however, have suggested that the exclusionary rule is not the most effective way to deter officials from violating Fourth Amendment rights. First and perhaps foremost, it can overdeter.[309] If the police are worried that the smallest technical misstep will result in exclusion of evidence,[310] they may forgo perfectly legitimate searches, and, as a result, criminals will escape arrest and likely commit more crimes. Second, it can underdeter: The exclusionary rule "awards windfalls to guilty criminal defendants while offering nothing at all to the innocent whose rights are equally violated."[311] Third, the exclusionary rule is an all-or-nothing remedy; there is no way to tailor the penalty to the severity of the constitutional violation. Looking in a glove compartment of a car becomes the legal equivalent of breaking down the front door in the middle of the night, body-searching every member of the family, and rifling through every drawer in the house. Finally, the rule can lead to legal outcomes clearly at variance with the truth and thus undermine faith in the legal system.[312]

Just as decoupling statutes maintain deterrence against private tortfeasors while offering a host of advantages over letting plaintiffs retain punitive damage awards, critics of the exclusionary rule believe that other remedies exist that will effectively deter police misconduct without the litany of disadvantages just discussed. By eliminating a windfall for guilty defendants, the criminal justice system can have its cake—legal searches and seizures—and eat it too—more precisely tailored deterrence and conviction of the guilty regardless of the provenance of evidence.

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306. *See* Doggett v. United States, 505 U.S. 647 (1992).

307. "The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated . . . ." U.S. CONST. amend. IV.

308. *See* Mapp v. Ohio, 367 U.S. 643 (1961).

309. *See* POSNER, *supra* note 39, at 749.

310. Few areas of law can rival the hypertechnical distinctions the courts have drawn between legal and illegal searches. *See generally* WAYNE R. LAFAVE & JEROLD H. ISRAEL, CRIMINAL PROCEDURE § 3.2 (2d ed. 1992 & Supp. 1995) ("Protected Areas and Interests"); *id.*, § 3.8 ("Stop and Frisk and Similar Lesser Intrusions").

311. Carol S. Steiker, *Second Thoughts About First Principles*, 107 HARV. L. REV. 820, 848 (1994).

312. *See generally* JOSEPH D. GRANO, CONFESSIONS, TRUTH, AND THE LAW (1993) (outlining at length the problems with constitutional protections of criminal defendants).

The prime candidate to replace the exclusionary rule is damage awards against officials who engage in illegal searches and seizures. Another scholar suggests reducing the sentences of criminals convicted with illegally obtained evidence.[313] Judges can calibrate these alternatives to match the seriousness of any constitutional violation, and, for this reason, overdeterrence is unlikely. Damages have the advantage of providing a remedy for the innocent as well as the guilty. Both vindicate the important social goal of rendering judgments that reflect the truth. If either or both of the alternative remedies can deter police misconduct at least as effectively as the exclusionary rule, they offer a host of additional benefits to society instead of a windfall to the guilty.

Criminal procedure reform seems a long way from the Windfall Profit Tax on Oil. Although the means differ significantly, society's goal in both cases—and in every other example studied in this Part—is identical: Take windfalls from their recipients and share the bounty with everyone. Thus, there is a unifying theme behind the disparate legal rules, an important theme for policymaking. That elected governments have seen fit to effectuate windfall capture in such a wide variety of circumstances is strong evidence that people are risk-averse regarding upside risk and desire sharing rules.

V. CONCLUSION

Optimal tax theory and individuals' risk aversion provide powerful efficiency justifications for capturing large and easily identified windfalls—gains independent of work, planning, or other productive activities that society wishes to reward. These redistributions can impose significant transaction and administrative costs and, moreover, can undermine incentives to behave productively. Thus, this Article has tempered optimism about windfall capture with cautionary discussions of contexts in which windfalls do not exist or the costs of capture exceed the benefits.

For example, capture is never desirable for private windfalls, where the number of winners and losers is relatively small. Misunderstanding what constitutes a windfall, courts overseeing private litigation often ignore the value of planning, identify windfalls where none exist, and undermine the incentives to engage in prudent forethought. Ironically, the very term windfall arose from a practice that likely involved nothing akin to an unearned gain.[314] It seems highly unlikely that the Crown and its nobles, lords of the medieval English forests, would have permitted peasants to

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313. *See* Akhil Reed Amar, *Fourth Amendment First Principles*, 107 HARV. L. REV. 757, 796 (1994).

314. *See supra* note 1 and accompanying text.

haul away windfallen branches that could have been harvested at any noticeable profit. The value of the wood shorn from trees as a result of storms, then, probably exceeded the labor cost of collecting it by only a small margin. The sovereign and the lords, it seems, simply abandoned their rights to a resource not worth recovering for commercial purposes. Peasants able to harvest the fallen branches at the least cost (for example, those living closest to the forests or those with the lowest opportunity cost for their time) would derive some marginal benefit from the free source of wood. This woodgathering differed little from modern-day soda can gathering: The recovery by the poor of low-value property abandoned by the (relatively) wealthy. Thus, the original windfall was no windfall at all.

When private windfalls actually exist, it is often too expensive to return the subject property to its true owner. In such cases, there are often wider social goals that dictate which party should get the windfall. Even when there is no societal interest at stake, attempted state capture of most private windfalls is not feasible: The costs of detection are high, and all the government accomplishes by imposing a windfall tax is to raise transaction costs among those few parties with knowledge of the lucky gain.

For public windfalls, where the number of winners and losers is large, detection is cheap and easy. Still, policymakers must proceed with caution in this context as well. Misguided capture mechanisms, such as the wartime excess profits taxes, fail to account properly for high administrative and deadweight costs. There is good reason to believe, however, that the Windfall Profit Tax on Oil provides a model for efficient capture. While necessarily complex, windfall capture mechanisms are becoming steadily more feasible for wealthier societies possessing powerful tools to gather and process information.

It is impossible to anticipate where and when future public windfalls will arise; by definition such events are surprises. Some hypothetical examples, however, help illustrate how modern states' expanding ability to gather and digest information may help separate windfallen chaff from earned wheat. Assume that later patent *Y* makes earlier patent *X* much more valuable in a way that, given the details of patent *X*, the inventor of *X* clearly never anticipated. If the state can make this determination with confidence, it should tax away the royalties earned by *X* that are attributable to *Y*. Similarly, the surprising growth of the Internet may make all the wires going into private homes more valuable as they become conduits for Web material in addition to data they were originally designed to carry (voice for phone wiring, video for cable television). If the companies never expected this incremental revenue stream, the state has a strong case for taxing away telephone and cable companies' profits due to Internet use. A government able to gather and analyze extensive data on the telephone and cable industries may be able to determine with sufficient confidence that their gains from the explosion in Internet use were largely unexpected windfalls.

Even when the case for capture is not clear, the windfall concept is a useful tool for thinking about a variety of issues, from progressive taxation to escheat, from insider trading to the Fourth Amendment's exclusionary rule. In all of these contexts, this Article has offered a consistent way to think about how society should deal with unearned benefits.